DOT HILL SYSTEMS CORP
Form 10-Q
May 10, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Quarterly Period Ended March 31, 2006

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from to

Commission file number 1-13317

DOT HILL SYSTEMS CORP.
(Exact name of registrant as specified in its charter)

Delaware	**13-3460176**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
2200 Faraday Avenue, Suite 100, Carlsbad, CA	**92008**
(Address of principal executive offices)	(Zip Code)

(760) 931-5500
(Registrant s telephone number, including area code)
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o Accelerated filer þ Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

The registrant had 44,610,949 shares of common stock, $0.001 par value, outstanding as of May 9, 2006.

DOT HILL SYSTEMS CORP.
FORM 10-Q
For the Quarter Ended March 31, 2006
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Part I. Financial Information

Item 1. Financial Statements

DOT HILL SYSTEMS CORP. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(In Thousands Except Per Share Amounts)
(Unaudited)

	December 31, 2005	March 31, 2006
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 108,803	$ 100,218
Short-term investments	13,431	14,535
Accounts receivable, net of allowance of $294 and $466	34,312	44,555
Inventories	2,804	2,893
Prepaid expenses and other	4,539	5,206
Deferred tax assets	5,762	5,762
Total current assets	169,651	173,169
Property and equipment, net	7,891	9,929
Goodwill	40,725	40,725
Other intangible assets, net	7,414	6,569
Deferred tax assets	41,379	43,949
Other assets	234	173
Total assets	$ 267,294	$ 274,514
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	$ 25,732	$ 34,511
Accrued compensation	3,561	3,362
Accrued expenses	3,633	4,695
Deferred revenue	1,327	450
Income taxes payable	60	27
Restructuring accrual	45	11
Total current liabilities	34,358	43,056
Other long-term liabilities	885	2,213
Total liabilities	35,243	45,269
Commitments and Contingencies (Note 11)		
Stockholders Equity:		
Preferred stock, $0.001 par value, 10,000 shares authorized, no shares issued or outstanding		

Common stock, $0.001 par value, 100,000 shares authorized, 44,417 and 44,610 shares issued and outstanding at December 31, 2005 and March 31, 2006, respectively	44	45
Additional paid-in capital	285,377	287,559
Accumulated other comprehensive loss	(118)	(132)
Accumulated deficit	(53,252)	(58,227)
Total stockholders equity	232,051	229,245
Total liabilities and stockholders equity	$ 267,294	$ 274,514

See accompanying notes to condensed consolidated financial statements.

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DOT HILL SYSTEMS CORP. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
AND COMPREHENSIVE INCOME (LOSS)
(In Thousands, Except Per Share Amounts)
(Unaudited)

	Three Months Ended March 31,	
	2005	**2006**
NET REVENUE	$ 58,011	$ 58,686
COST OF GOODS SOLD	44,734	47,525
GROSS PROFIT	13,277	11,161
OPERATING EXPENSES:		
Sales and marketing	4,651	4,153
Research and development	4,713	9,712
General and administrative	2,631	6,153
Total operating expenses	11,995	20,018
OPERATING INCOME (LOSS)	1,282	(8,857)
OTHER INCOME:		
Interest income, net	634	1,312
Other income, net	75	
Total other income, net	709	1,312
INCOME (LOSS) BEFORE INCOME TAXES	1,991	(7,545)
INCOME TAX BENEFIT	(111)	(2,570)
NET INCOME (LOSS)	$ 2,102	$ (4,975)
NET INCOME (LOSS) PER SHARE:		
Basic	$ 0.05	$ (0.11)
Diluted	$ 0.05	$ (0.11)
WEIGHTED AVERAGE SHARES USED TO CALCULATE NET INCOME (LOSS) PER SHARE:		
Basic	43,741	44,518
Diluted	45,717	44,518

COMPREHENSIVE INCOME (LOSS):		
Net income (loss)	$ 2,102	$ (4,975)
Foreign currency translation adjustments	16	(40)
Net unrealized gain (loss) on short-term investments	(133)	26
Comprehensive income (loss)	$ 1,985	$ (4,989)

See accompanying notes to condensed consolidated financial statements.

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DOT HILL SYSTEMS CORP. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In Thousands)
(Unaudited)

	Three Months Ended March 31, 2005	Three Months Ended March 31, 2006
Cash Flows From Operating Activities:		
Net income (loss)	$ 2,102	$ (4,975)
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Depreciation and amortization	2,048	1,659
Loss on disposal of property and equipment	39	19
Provision for doubtful accounts	(21)	15
Stock-based compensation expense	5	1,228
Gain on sale of short-term investments	(8)	
Deferred taxes		(2,570)
Changes in operating assets and liabilities:		
Accounts receivable	2,537	(10,240)
Inventories	624	(89)
Prepaid expenses and other assets	(441)	(597)
Accounts payable	(7,719)	7,487
Accrued compensation and expenses	(780)	844
Deferred revenue	(33)	(886)
Income taxes payable	(279)	(33)
Restructuring accrual	(7)	(34)
Other long-term liabilities	(21)	1,356
Net cash used in operating activities	(1,954)	(6,816)
Cash Flows From Investing Activities:		
Purchases of property and equipment	(375)	(1,642)
Sales and maturities of short-term investments	21,177	7,775
Purchases of short-term investments	(42,268)	(8,853)
Net cash used in investing activities	(21,466)	(2,720)
Cash Flows From Financing Activities:		
Proceeds from sale of stock to employees	550	603
Proceeds from exercise of stock options and warrants	132	351
Net cash provided by financing activities	682	954
Effect of Exchange Rate Changes on Cash	15	(3)

Net Decrease in Cash and Cash Equivalents	(22,723)	(8,585)
Cash and Cash Equivalents, beginning of period	67,496	108,803
Cash and Cash Equivalents, end of period	$ 44,773	$ 100,218
Supplemental Disclosures of Cash Flow Information:		
Construction in progress costs incurred but not paid	$	$ 1,227
Cash paid for interest	$	$
Cash paid for income taxes	$ 350	$ 19

See accompanying notes to condensed consolidated financial statements.

DOT HILL SYSTEMS CORP. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared by Dot Hill Systems Corp. (referred to herein as Dot Hill, we, our or us) pursuant to the rules and regulations of the Securities and Exchange Commission, or the SEC. Accordingly, they do not include all of the information and disclosures required by accounting principles generally accepted in the United States, or GAAP, for complete financial statements. Certain reclassifications have been made to prior periods to conform to current presentations. In the opinion of management, all adjustments and reclassifications considered necessary for a fair and comparable presentation have been included and are of a normal recurring nature. The unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2005. Operating results for the three months ended March 31, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006.

The preparation of our financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Revenues are recognized pursuant to applicable accounting standards, including SEC Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition* and Statement of Position (SOP) No. 97-2, *Software Revenue Recognition*.

We recognize revenue for non-software product sales upon transfer of title to the customer. Reductions to revenue for estimated sales returns are also recorded at that time. These estimates are based on historical sales returns, changes in customer demand and other factors. If actual future returns and allowances differ from past experience, additional allowances may be required. Certain of our sales arrangements include multiple elements. Generally, these arrangements include delivery of the product, installation, training and product maintenance. Maintenance related to product sales entitles the customer to basic product support and significantly greater response time in resolving warranty related issues. We allocate revenue to each element of the arrangement based on its relative fair value. For maintenance contracts this is typically the price charged when such contracts are sold separately or renewed. Because professional services related to installation and training can be provided by other third party organizations, we allocate revenue related to professional services based on the Company s stated billing rates which are consistent with amounts charged separately and other companies providing similar services, i.e., the market rate for such services. Revenue from product maintenance contracts is deferred and recognized ratably over the contract term, generally 12 months. Revenue from installation, training and consulting is recognized as the services are performed.

For software sales, we apply SOP No. 97-2*,* whereby revenue is recognized from software licenses at the time the product is delivered, provided there are no significant obligations related to the sale, the resulting receivable is deemed collectible and there is vendor-specific objective evidence supporting the value of the separate contract elements. For arrangements with multiple elements, we allocate revenue to each element using the residual method based on vendor specific objective evidence of the undelivered items. A portion of the arrangement fee equal to the fair value of the undelivered elements, typically software maintenance contracts, is deferred and recognized ratably over the contract term, generally 12 months. Vendor specific objective evidence is based on the price charged when the element is sold separately. A typical arrangement includes a software-licensing fee and maintenance agreement.

2. Change in Accounting for Stock-Based Compensation

On January 1, 2006, we adopted Statement of Financial Accounting Standard (SFAS) No. 123(R), *Share-Based Payment*, which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees, directors and consultants, including stock option grants and purchases of stock made pursuant to our 2000 Amended and Restated Equity Incentive Plan, or the 2000 EIP, our 2000 Amended and Restated Non-Employee Directors Stock Option Plan, or the 2000 NEDSOP, and our 2000 Amended and Restated Employee Stock Purchase Plan, or the 2000 ESPP, based on estimated fair values. SFAS No. 123(R) supercedes our previous accounting under Accounting Principles Board Opinion (APB) No. 25, *Accounting for Stock Issued to Employees*. In

March 2005, the SEC issued SAB No. 107, *Share-Based Payment*, and we have applied SAB No. 107 s provisions in our adoption of SFAS No. 123(R).

We adopted SFAS No. 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006 as further described below. In accordance with the modified prospective transition method, our unaudited condensed consolidated financial statements for the three months ended March 31, 2005 have not been restated to reflect, and do not include, the impact of the adoption of SFAS No. 123(R).

SFAS No. 123(R) requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the award s portion that is ultimately expected to vest is recognized as expense over the requisite service periods in the accompanying unaudited condensed consolidated financial statements for the three months ended March 31, 2006. Prior to the adoption of SFAS No. 123(R), we accounted for share-based awards to employees and directors using the intrinsic value method in accordance with APB No. 25 as allowed under SFAS No. 123, *Accounting for Stock-Based Compensation*. Under the intrinsic value method, share-based compensation expense was only recognized by Dot Hill if the exercise price of the grant was less than the fair market value of the underlying stock at the date of grant. No stock-based compensation expense was recorded by Dot Hill in 2005.

As of March 31, 2006, total unrecognized share-based compensation cost related to unvested stock options was $6.1 million, which is expected to be recognized over a weighted average period of approximately 3.4 years. We have included the following amounts for share-based compensation cost, including the cost related to the 2000 EIP, 2000 NEDSOP and 2000 ESPP, in the accompanying unaudited condensed consolidated statement of operations for the three months ended March 31, 2006 (amounts in thousands):

		Three Months Ended March 31, 2006
Cost of goods sold	$	51
Sales and marketing		87
Research and development		180
General and administrative		910
Share-based compensation expense before taxes		1,228
Related deferred income tax benefits		(183)
Share-based compensation expense, net of income taxes	$	1,045
Net share-based compensation expense per basic and diluted common share	$	0.02

Share-based compensation expense recognized under SFAS No. 123(R) for the quarter ended March 31, 2006 included $1.0 million from stock options and $0.2 million from the 2000 ESPP. Share-based compensation expense recognized during the three months ended March 31, 2006 included (1) compensation expense for awards granted prior to, but not yet fully vested as of January 1, 2006, and (2) compensation expense for the share-based payment awards granted subsequent to December 31, 2005, based on the grant date fair values estimated in accordance with the provisions of SFAS No. 123(R). SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In our pro forma disclosures required under SFAS No. 123 for the periods prior to 2006, we accounted for forfeitures as they occurred. We have historically and continue to estimate the fair value of share-based awards using the Black-Scholes option-pricing model. Total unrecognized share-based compensation cost related to unvested stock options has been adjusted for estimated forfeitures.

Stock Incentive Plans

2000 EIP. During 2006 and 2005, we primarily granted options to purchase common stock to our employees and consultants under the 2000 EIP. These options expire 10 years from the date of grant and typically vest over four years, with 25% of the shares subject to the option vesting one year from the date of grant and the remaining shares subject to the option vesting ratably thereafter on a monthly basis. The number of shares of common stock reserved for issuance under the 2000 EIP is increased annually on the date of our meeting of stockholders by an amount equal to the lesser of (A) two percent of our outstanding shares as of the date of our annual meeting of stockholders, (B) 1,000,000 shares or (C) an amount determined by our board of directors. If an option is surrendered or for any other reason ceases to be exercisable in whole or in part, the shares with respect to which the option was not exercised shall continue to be available under the 2000 EIP. As of March 31, 2006, options to purchase 5,085,668 shares of common stock were outstanding under the 2000 EIP and the options to purchase 351,447 shares of common stock remained available for grant under the 2000 EIP.

2000 NEDSOP. Under the 2000 NEDSOP, nonqualified stock options to purchase common stock are automatically granted to our non-employee directors upon appointment to our board of directors (initial grants) and upon each of our annual meeting of stockholders (annual grants). Options granted under the 2000 NEDSOP expire 10 years from the date of the grant. Initial grants vest over four years, with 25% of the shares subject to the option vesting one year from the date of grant and the remaining shares subject to the option vesting ratably thereafter on a monthly basis. Annual grants are fully vested on the date of grant. 500,000 shares of common stock are reserved for issuance under the 2000 NEDSOP. As of March 31,

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2006, options to purchase 324,917 shares of common stock were outstanding under the 2000 NEDSOP and options to purchase 102,499 shares of common stock remained available for grant under the 2000 NEDSOP.

2000 ESPP. The 2000 ESPP qualifies under the provisions of Section 423 of the Internal Revenue Code, or IRC, and provides our eligible employees, as defined in the 2000 ESPP, with an opportunity to purchase shares of our common stock at 85% of fair market value, as defined in the 2000 ESPP. There were 102,621 and 121,341 shares issued for the 2000 ESPP periods that ended in the three months ended March 31, 2005 and 2006, respectively.

Share-Based Compensation Cost under SFAS No. 123

Prior to January 1, 2006, we disclosed compensation cost in accordance with SFAS No. 123. The provisions of SFAS No. 123 require Dot Hill to disclose the assumptions used in calculating the fair value pro forma expense. Had compensation expense for the plans been determined based on the fair value of the options at the grant dates for awards under the plans consistent with SFAS No. 123, our net income for the three months ended March 31, 2005 would have been as follows (amounts in thousands, except per share data):

	Three Months Ended March 31, 2005	
Net income as reported	$	2,102
Stock-based compensation, as reported		5
Total stock-based compensation determined under fair value based method for all awards		(1,393)
Pro forma income	$	714
Basic net income per share, as reported	$	0.05
Diluted net income per share, as reported	$	0.05
Basic net income per share, SFAS No. 123 adjusted	$	0.02
Diluted net income per share, SFAS No. 123 adjusted	$	0.02

Pro forma disclosures for the three months ended March 31, 2006 are not presented because the amounts are recognized in the unaudited condensed consolidated statement of operations.

To estimate compensation expense which would have been recognized under SFAS No. 123 for the three months ended March 31, 2005 and the compensation cost that was recognized under SFAS No. 123(R) for the three months ended March 31, 2006, we use the Black-Scholes option-pricing model with the following weighted-average assumptions for equity awards granted:

	2000 EIP and 2000 NEDSOP Three Months Ended March 31,		**2000 ESPP Three Months Ended March 31,**	
	2005	**2006**	**2005**	**2006**
Risk-free interest rate	3.71%	4.81%	3.36%	4.40%
Expected dividend yield	%	%	%	%
Volatility	81%	68%	85%	68%
Expected life	4.0 years	5.6 years	1 year	1 year

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The risk-free interest rate is based on the implied yield available on U.S. Treasury issues with an equivalent remaining term. We have not paid dividends in the past and do not plan to pay any dividends in the future. The expected volatility is based on implied volatility of our stock for the related vesting period. The expected life of the equity award is based on historical experience.

Activity and pricing information regarding all options to purchase shares of common stock are summarized as follows:

	Number of shares	Weighted average exercise price	Weighted average remaining contractual term (in years)	Aggregate intrinsic value (in millions)
Outstanding at December 31, 2005	4,830,811	$ 6.52		
Granted	1,002,500	6.82		
Forfeited	(373,685)	6.14		
Exercised	(47,041)	5.76		
Outstanding at March 31, 2006	5,412,585	$ 6.61	7.54	$ 8.6
Exercisable at March 31, 2006	3,520,948	$ 6.82	6.58	$ 6.9

The weighted average grant-date fair values of options granted during the three months ended March 31, 2006 and 2005 were $4.32 per share and $3.75 per share, respectively. The total intrinsic value of options exercised during each of the three months ended March 31, 2006 and 2005 was $0.1 million.

A summary of the status of our non-vested stock options as of March 31, 2006 and changes during the quarter then ended are presented below.

	Number of Shares	**Weighted average grant-date fair value per share**
Nonvested at December 31, 2005	1,703,142	$ 3.49
Granted	1,002,500	$ 4.32
Vested	(458,922)	$ 3.54
Forfeited	(355,083)	$ 3.71
Nonvested at March 31, 2006	1,891,637	$ 3.87

During the three months ended March 31, 2006, financing cash generated from share-based compensation arrangements amounted to $0.3 million for the purchase of shares upon exercise of options and $0.6 million collected for the purchase of shares through the 2000 ESPP. We issue new shares from the respective plan share reserves upon exercise of options to purchase common stock and for purchases through the 2000 ESPP.

Additional information regarding options outstanding for all plans as of March 31, 2006, is as follows:

	Options Outstanding	**Options Exercisable**
	Weighted	

Range of Exercise Prices	Number Outstanding	Average Remaining Contractual Life (yrs.)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$1.34 3.10	1,057,964	5.98	\$ 2.41	1,011,539	\$ 2.38
\$3.15 5.50	912,433	6.42	4.67	554,318	4.45
\$5.70 6.25	957,500	8.37	6.12	568,123	6.09
\$6.36 6.87	1,119,405	9.57	6.71	96,685	6.41
\$6.88 12.49	967,133	7.10	10.02	892,133	10.28
\$12.81 17.14	398,150	7.66	14.79	398,150	14.79
Total	5,412,585	7.54	\$ 6.61	3,520,948	\$ 6.82

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The aggregate intrinsic value in the table above is based our closing stock price of $7.10 per share as of the last business day of the three months ended March 31, 2006, which amount would have been received by the optionees had all options been exercised on that date. The total fair value of options to purchase common stock that vested during the three months ended March 31, 2006 and 2005 was $1.6 million and $2.0 million, respectively.

3. Net Income (Loss) Per Share

Basic net income (loss) per share is calculated by dividing net income by the weighted average number of common shares outstanding during the period.

Diluted net income (loss) per share reflects the potential dilution of securities by including common stock equivalents, such as stock options and stock warrants in the weighted average number of common shares outstanding for a period, if dilutive.

The following table sets forth a reconciliation of the basic and diluted number of weighted average shares outstanding used in the calculation of net income (loss) per share (in thousands):

	Three Months Ended March 31,	
	2005	**2006**
Shares used in computing basic net income (loss) per share	43,741	44,518
Dilutive effect of warrants and common stock equivalents	1,976	
Shares used in computing diluted net income (loss) per share	45,717	44,518

For the three months ended March 31, 2005, outstanding options to purchase 2,084,498 shares of common stock with exercises prices ranging from $6.25 to $17.14 per share were outstanding, but were not included in the calculation of diluted loss per share because their effect was antidilutive.

For the three months ended March 31, 2006, outstanding options to purchase 5,001,319 shares of common stock with exercises prices ranging from $1.34 to $17.14 per share and outstanding warrants to purchase 1,714,679 shares of common stock at prices ranging from $2.97 to $4.50 were not included in the calculation of diluted loss per share because their effect was antidilutive.

4. Short-Term Investments

The following table summarizes our short-term investments as of March 31, 2006 (in thousands):

	Cost	Unrealized Losses	Unrealized Gains	Fair Value
U.S. Government securities	$ 5,699	$ (15)	$	$ 5,684
Corporate debt	8,850		1	8,851
	$ 14,549	$ (15)	$ 1	$ 14,535

For the three months ended March 31, 2006, we did not recognize any gross realized gains on these investments.

Expected maturities will differ from contractual maturities because the issuers of the securities may have the right to prepay obligations without prepayment penalties. The cost and fair value of short-term investments at March 31, 2006 by contractual maturity are shown below (in thousands).

	Cost	Fair Value
Due in one year or less	$ 8,850	$ 8,851
Due after one year through five years	5,699	5,684
Total	$ 14,549	$ 14,535

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The following table shows the gross unrealized losses and fair values of our investments in individual securities that have been in a continuous unrealized loss position, deemed to be temporary, for less than and greater than 12 months, aggregated by investment category, at March 31, 2006 (in thousands):

	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Government securities	$	$	$ 5,684	$ (15)	$ 5,684	$ (15)
Corporate debt	8,851				8,851	
Total	$ 8,851	$	$ 5,684	$ (15)	$ 14,535	$ (15)

U.S. Government Securities. The unrealized losses on our investments in U.S. Government securities were caused by interest rate increases. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the amortized cost of the investment. Because we have the ability and intent to hold these investments until a recovery of fair value, which may be maturity, we do not consider these investments to be other-than-temporarily impaired at March 31, 2006.

Corporate Debt Securities. Our investments in debt securities consist primarily of investments in corporate bonds.

5. Inventories

Inventories are stated at the lower of cost (first-in, first-out) or market value. The following is a summary of inventories (in thousands):

	December 31, 2005	March 31, 2006
Purchased parts and materials	$ 1,058	$ 652
Finished goods	1,746	2,241
	$ 2,804	$ 2,893

6. Goodwill and Other Intangible Assets

Under the provisions of SFAS No. 142, *Goodwill and Other Intangible Assets,* goodwill and intangible assets with indefinite lives are not amortized, but instead are tested for impairment at least annually or more frequently if impairment indicators arise. All of our remaining identified intangible assets are considered to have finite lives and are being amortized in accordance with this statement.

Intangible assets that are subject to amortization under SFAS No. 142 consist of the following as of March 31, 2006 (in thousands):

	Gross	Accumulated Amortization	Net
Core technology	$ 5,000	$ (2,315)	$ 2,685
Developed technology	2,600	(2,168)	432
Customer relationships	2,500	(1,487)	1,013
Backlog	100	(100)	
Licensed Patent Portfolio	2,570	(131)	2,439
Total other intangible assets	$ 12,770	$ (6,201)	$ 6,569

As of March 31, 2006, the weighted average amortization period for the above intangibles is 4.0 years.

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Estimated future amortization expense related to other intangible assets as of March 31, 2006 is as follows (in thousands):

Years ending December 31,	
2006 (remaining 9 months)	$ 2,188
2007	2,101
2008	1,255
2009	514
2010	511
Total	$ 6,569

7. Product Warranties

We generally extend to our customers the warranties provided to us by our suppliers and, accordingly, the majority of our warranty obligations to customers are covered by supplier warranties. For warranty costs not covered by our suppliers, we provide for estimated warranty costs in the period the revenue is recognized. There can be no assurance that our suppliers will continue to provide such warranties to us in the future, which could have a material adverse effect on our operating results and financial condition. Estimated liabilities for product warranties are included in accrued expenses. The changes in our aggregate product warranty liability are as follows for the three months ended March 31, 2006 (in thousands):

	Three Months Ended March 31, 2006
Balance, beginning of period	$ 746
Charged to operations	630
Deductions for costs incurred	(676)
Balance, end of period	$ 700

8. Restructurings

Restructuring liabilities at March 31, 2006 were originally recorded in 2001 and 2002 and pertain to leases for former offices located in New York, Chicago and Carlsbad that extend through 2006. As of March 31, 2006, the remaining restructuring liability pertains to only the Carlsbad office.

The following is a summary of restructuring activity recorded during the three months ended March 31, 2006 (in thousands):

March 2001 Restructuring

	Accrued Restructuring Expenses at December 31, 2005	Additional Restructuring Expenses	Current Amounts Utilized	Accrued Restructuring Expenses at March 31, 2006
Facility closures and related costs	$ 45	$	$ (34)	$ 11

We believe that there are no unresolved issues or additional liabilities that may result in a significant adjustment to restructuring expenses accrued as of March 31, 2006.

9. Income Taxes

We recorded an income tax benefit of $0.1 and $2.6 million for the three months ended March 31, 2005 and 2006, respectively. Our effective income tax rate was 34.1% for the three months ended March 31, 2006.

Our income tax benefit for the three months ended March 31, 2005 included the receipt by our European subsidiary of $0.2 million from European taxing authorities related to a 2002 loss that was carried back to the years 1998 through 2001.

We currently anticipate an effective income tax rate of approximately 34.1% for the year ended December 31, 2006.

At December 31, 2005, based on the weight of available evidence, including cumulative profitability in recent years, we determined that it was more likely than not that a portion of our United States deferred tax assets would be realized and, at December 31, 2005, eliminated $47.1 million of valuation allowance associated with our United States deferred tax assets. The elimination of valuation allowance resulted in a $16.4 million decrease to goodwill to the extent of our acquired net deferred tax assets, a $5.4 million increase to equity for net operating losses arising from stock option deductions, with the remaining $25.3 million recognized as an increase in earnings for the year ended December 31, 2005. As a result of our elimination of valuation allowance associated with United States deferred tax assets, our effective tax rate in subsequent periods is likely to more closely resemble the applicable federal and state statutory tax rates.

Excluding the impact of the loss carryback, our effective income tax rate was 2.5% for the three months ended March 31, 2005.

As of December 31, 2005, a valuation allowance of $3.6 million has been provided for the foreign deferred tax assets based upon our assessment of the future realizability of certain foreign deferred tax assets, as it is more likely than not, that sufficient taxable income will not be generated to realize these temporary differences.

As of December 31, 2005, we had federal and state net operating losses of approximately $113.1 million and $49.0 million, which begin to expire in the tax years ending 2009 and 2006, respectively. In addition, we have federal tax credit carryforwards of $2.9 million, of which approximately $0.5 million can be carried forward indefinitely to offset future taxable income, and the remaining $2.4 million will begin to expire in the tax year ending 2008. We also have state tax credit carryforwards of $3.1 million, of which $2.9 million can be carried forward indefinitely to offset future taxable income, and the remaining $0.2 million will begin to expire in the tax year ending 2006.

Due to our equity transactions, an ownership change, within the meaning of IRC Section 382, occurred on September 18, 2003. As a result, annual use of our federal net operating loss and credit carry forwards is limited to (i) the aggregate fair market value of Dot Hill immediately before the ownership change multiplied by (ii) the long-term tax-exempt rate (within the meaning of IRC Section 382 (f)) in effect at that time. The annual limitation is cumulative and, therefore, if not fully utilized in a year, can be utilized in future years in addition to the IRC Section 382 limitation for those years.

As a result of our acquisition of Chaparral Network Storage, Inc., or Chaparral, an ownership change, within the meaning of IRC Section 382, occurred on February 23, 2004. As a result, annual use of Chaparral s federal net operating loss and credit carry forwards acquired in the transaction may be limited. The annual limitation is cumulative and, therefore, if not fully utilized in a year, can be utilized in future years in addition to the IRC Section 382 limitation for those years.

We have not provided for any residual United States income taxes on the earnings from our foreign subsidiaries because such earnings are intended to be indefinitely reinvested. Such residual United States income taxes, if any, would be insignificant.

10. Accumulated Other Comprehensive Income (Loss)

The components of accumulated other comprehensive loss are as follows (in thousands):

	Foreign Currency Items	Unrealized Gain (Loss) on Securities	Total
Balance, December 31, 2005	$ (78)	$ (40)	$ (118)
Quarterly change	(40)	26	(14)
Balance, March 31, 2006	$ (118)	$ (14)	$ (132)

11. Commitments and Contingencies

Commitments

Consulting Agreement with Former Executive

In March 2006, we entered into a consulting agreement with our former Chief Executive Officer, James L. Lambert. Pursuant to the consulting letter agreement, Mr. Lambert will perform consulting services for us during a three-year period beginning as of March 1, 2006 for a consulting fee of $16,666 per month. The vesting of 218,125 of Mr. Lambert s stock options, with an average exercise price of $5.63 per share, was accelerated in full in connection with the consulting agreement, and such stock options will continue to be exercisable during the consulting period in accordance with their terms. Mr. Lambert will be restricted from competing with us during the consulting period, and the consulting period will terminate early upon an acquisition of us, Mr. Lambert s election or Mr. Lambert s death or permanent disability. In the event of any such early termination, Mr. Lambert will receive a lump sum payment equal to the amount he would have been eligible to receive if the consulting period continued for the full original three-year period. Based on the terms of this agreement, we recognized a non-cash stock option expense of $0.7 million related to the acceleration of stock options and consulting fees of $0.6 million during the three months ended March 31, 2006.

Effective July 1, 2004, we entered into a credit agreement with Wells Fargo Bank, National Association, or Wells Fargo, which allows us to borrow up to $30.0 million under a revolving line of credit that expires July 1, 2006. Amounts loaned under the credit agreement bear interest at our option at a fluctuating rate per annum equal to the Prime Rate in effect from time to time, or at a fixed rate per annum determined by Wells Fargo to be 0.65% above LIBOR in effect on the first day of the applicable fixed rate term. In connection with the credit agreement, to the extent we have outstanding borrowings, we have granted Wells Fargo a security interest in our investment management account maintained with Wells Capital Management Incorporated. As of December 31, 2005 and March 31, 2006, there were no balances outstanding under this line of credit. The credit agreement limits any new borrowings, loans, or advances outside of the credit agreement to an amount less than $1.0 million.

Contingencies

Crossroads Systems Litigation

On October 17, 2003, Crossroads Systems, Inc., or Crossroads, filed a lawsuit against us in the United States District Court in Austin, Texas, alleging that our products infringe two United States patents assigned to Crossroads, Patent Numbers 5,941,972 and 6,425,035. We were served with the lawsuit on October 27, 2003. Chaparral was added as a party to the lawsuit in March 2004. The patents involve storage routers and methods for providing virtual local storage. Patent Number 5,941,972 involves the interface of Small Computer Systems Interface, or SCSI, storage devices and the Fibre Channel protocol and Patent Number 6,425,035 involves the interface of any one-transport medium and a second transport medium. We believe that we have meritorious defenses to Crossroads claims and are in the process of vigorously defending against them. The outcome is uncertain and no amounts have been accrued as of March 31, 2006. However, we expect to incur significant legal expenses in connection with this litigation. These defense costs, and other expenses related to this litigation, will be expensed as incurred and will negatively affect our operating results. A trial in the matter is expected to commence on June 5, 2006.

Chaparral Securities Class Action

In August 2004, a class action lawsuit was filed against, among others, Chaparral and a number of its former officers and directors in the United States District Court for the Central District of California. The lawsuit, among other things, alleges violations of federal and state securities laws and purports to seek damages on behalf of a class of shareholders who held interests in limited liability companies that had purchased, among other securities, Chaparral stock during a defined period prior to our acquisition of Chaparral. In May 2005, the Second Amended Complaint was dismissed with leave to amend. Plaintiffs filed a Third Amended Complaint, which the Court again dismissed with leave to amend in November of 2005 as to Chaparral and certain other defendants. Plaintiffs declined to amend within the proscribed period, and final judgment was entered in February 2006. Plaintiffs filed a notice of appeal in the United States District Court of Appeals for the Ninth Circuit, though they have not filed their opening papers.

Plaintiffs filed a related action in the Superior Court of the State of California, Orange County, in December of 2005, alleging many of the same claims. That action has been stayed pending the outcome of the federal appeal. We believe that the claims against Chaparral and its former officers and directors are without merit and are in the process of vigorously defending against them. The outcome is uncertain and no amounts have been accrued as of March 31, 2006.

Dot Hill Securities Class Actions and Derivative Suits

In late January and early February 2006, numerous purported class action complaints were filed against us in the United States District Court for the Southern District of California. The complaints allege violations of federal securities laws related to alleged inflation in our stock price in connection with various statements and alleged omissions to the public and to the securities markets and declines in our stock price in connection with the restatement of certain of our quarterly financial statements for fiscal year 2004, and seeking damages therefore. The court should approve a lead plaintiff(s) and approve lead counsel within the next 30 days. After the lead plaintiff files a consolidated class action complaint, or a consolidated complaint, we will move to dismiss the consolidated complaint.

In addition, three complaints purporting to be derivative actions have been filed in California state court against certain of our directors and executive officers. These complaints are based on the same facts and circumstances described in the federal class action complaints and generally allege that the named directors and officers breached their fiduciary duties by failing to oversee adequately our financial reporting. Each of the complaints generally seeks an unspecified amount of damages. The cases are in the very preliminary stages. We believe the allegations against us and certain of our directors and executive officers in this action are without merit and we intend to vigorously defend against these claims. We are seeking dismissal of each derivative action by demurring to the complaints. The outcome is uncertain and no amounts have been accrued as of March 31, 2006.

Other Litigation

We are involved in certain other legal actions and claims arising in the ordinary course of business. Management believes that the outcome of such other litigation and claims will not have a material adverse effect on our financial condition or operating results.

Other

In the fourth quarter of 2004, we made a payment of approximately $0.4 million to the State of New York to settle amounts related to a field audit of our franchise tax return. During the quarter ended March 31, 2005 we submitted tax returns to the City of New York and made a payment as an offer to settle in an amount similar to that accepted by the State of New York as described above. New York City is currently reviewing the returns, and we are waiting for a reply as to whether or not they have accepted the revised liability and payment as submitted. Amounts related to this matter have been previously accrued for.

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12. Segments and Geographic Information

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by our chief operating decision-maker, or decision making group, in deciding how to allocate resources and in assessing performance. Our chief operating decision-maker is our Chief Executive Officer. Our operating segments are managed separately because each segment represents a strategic business unit that offers different products or services.

Our operating segments are organized on the basis of products and services. We have identified operating segments that consist of our SANnet® family of systems, legacy and other systems, and services. We currently evaluate performance based on stand-alone segment revenue and gross margin. Because we do not currently maintain information regarding operating income at the operating segment level, such information is not presented.

Sales to our largest channel partner accounted for approximately 86% and 88% of our net revenue during the three months ended March 31, 2005 and March 31, 2006, respectively.

Information concerning revenue by product and service is as follows (in thousands):

	SANnet Family	Legacy and Other	Services	Total
Three months ended:				
March 31, 2006:				
Net revenue	$57,146	$ 639	$901	$58,686
Gross profit	$10,598	$ 62	$501	$11,161
March 31, 2005:				
Net revenue	$55,644	$1,586	$781	$58,011
Gross profit	$12,389	$ 338	$550	$13,277

Information concerning operating assets by product and service, derived by specific identification for assets related to specific segments and an allocation based on segment volume for assets related to multiple segments, is as follows (in thousands):

	SANnet Family	Legacy and Other	Services	Total
As of:				
March 31, 2006	$270,677	$1,629	$2,208	$274,514
December 31, 2005	$256,028	$8,240	$3,026	$267,294

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Information concerning principal geographic areas in which we operate is as follows (in thousands):

	Three Months Ended March 31, 2005	Three Months Ended March 31, 2006
Net revenue:		
United States	$ 54,066	$ 55,019
Europe	2,473	2,234
Asia	1,472	1,433
	$ 58,011	$ 58,686
Operating income (loss):		
United States	$ 1,778	$ (8,724)
Europe	(473)	(135)
Asia	(23)	2
	$ 1,282	$ (8,857)

Net revenue is recorded in the geographic area in which the sale is originated.

13. Recent Accounting Pronouncements

In May 2005, the Financial Accounting Standards Board, or FASB, issued Statement No. 154, *Accounting Changes and Error Corrections,* which requires retrospective application to prior periods financial statements of a voluntary change in accounting principle and that a change in method of depreciation, amortization, or depletion for long-lived, nonfinancial assets be accounted for as a change in accounting estimate that is effected by a change in accounting principle. Statement No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005.

In June 2005, the FASB issued Staff Position (FSP) No. 143-1, *Accounting for Electronic Equipment Waste Obligations*, which provides guidance on the accounting for obligations associated with the Directive on Waste Electrical and Electronic Equipment, or the WEEE Directive, which was adopted by the European Union. FSP No. 143-1 provides guidance on accounting for the effects of the WEEE Directive with respect to historical waste and waste associated with products on the market on or before August 13, 2005. FSP No. 143-1 requires commercial users to account for their WEEE obligation as an asset retirement liability in accordance with FASB Statement No. 143, *Accounting for Asset Retirement Obligations.* FSP No. 143-1 was required to be applied to the later of the first reporting period ending after June 8, 2005 or the date of the adoption of the WEEE Directive into law by the applicable European Union member country. The WEEE Directive has been adopted into law by the majority of European Union member countries in which we have significant operations. We adopted the provisions of FSP No. 143-1 as it relates to these countries with no material impact on our financial statements. We will apply the guidance of FSP No. 143-1 as it relates to the remaining European Union member countries in which we operate when those countries have adopted the WEEE Directive into law. The effect of applying FSP No. 143-1 in the remaining countries in future periods is not expected to have a material effect on our results of operations or financial condition.

On February 23, 2006, the FASB issued FSP No. FAS 123(R)-4, *Classification of Options or Similar Instruments Issued as Employee Compensation That Allow for Cash Settlement Upon the Occurrence of a Contingent Event*. FSP No. FAS No. 123(R)-4 requires that an award of stock options or similar instruments that otherwise meet the criteria for equity classification, but contains a cash settlement feature that can require the entity to settle the award in cash only upon the occurrence of a contingent event that is outside the employee s control, should be classified as a liability only when the event is probable of occurring. FSP No. FAS 123(R)-4 is effective for our first reporting period beginning after February 3, 2006. We do not believe that the adoption of FSP No. FAS 123(R)-4 will have a material effect on our results of operations or financial condition.

14. Subsequent Events

On April 6, 2006, we amended our change of control agreement with Dana W. Kammersgard, President and Chief Executive Officer, and entered into change of control agreements with Patrick E. Collins, Chief Operating Officer, and Philip A. Davis, Senior Vice President of Sales and Marketing. Mr. Kammersgard s amended change of control agreement provides that, in the event of an acquisition of Dot Hill or similar corporate event, Mr. Kammersgard s then remaining unvested stock and options will become fully vested and he will be entitled to a lump sum cash payment equal to 125% of his annual base salary then in effect, reduced by any severance payments payable under his employment agreement. Mr. Collins change of control agreement provides that if Mr. Collins employment with us is terminated, other than for cause, in connection with an acquisition of Dot Hill or similar corporate event, Mr. Collins then remaining unvested stock and options will become fully vested and he will be entitled to a lump sum cash payment equal to 125% of his annual base salary then in effect. Mr. Davis change of control agreement provides that if Mr. Davis employment with us is terminated, other than for cause, in connection with an acquisition of Dot Hill or similar corporate event, Mr. Davis then remaining unvested stock and options will become fully vested and he will be entitled to a lump sum cash payment equal to 125% of his annual base salary then in effect.

Also on April 6, 2006, we entered into a severance agreement with Shad L. Burke, Interim Chief Financial Officer, Vice President of Finance, Corporate Controller and Assistant Secretary, that provides that if, within the next two years, we terminate Mr. Burke s employment with us, other than for cause, or Mr. Burke terminates his employment with us for good reason, Mr. Burke will be entitled to a single lump sum payment equal to six months of his base salary as in effect at the time of such termination.

On April 25, 2006, we were informed by Sun Microsystems, Inc., or Sun, of its decision to move potential future supply of a new, low-end, entry-level storage product to another party. The project had previously been directed solely to Dot Hill. We believe that Sun s decision to re-direct the award to another party will not impact our current SE3000 product line being sold to Sun. As a result of Sun s decision to re-direct the low-end, entry-level storage product to another party, the fair value of our reporting units has been affected. As a result of this impairment indicator, during the quarter ended June 30, 2006 we will need to evaluate whether goodwill and other intangibles have been impaired under SFAS No. 142. Additionally, we considered the likelihood of future realization of our deferred tax assets and concluded that based on the weight of available evidence, including cumulative profitability in recent years, it was more likely than not that our United States deferred tax assets will be realized.

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations
Cautionary Statement for Forward-Looking Information

Certain statements contained in this report, including, statements regarding the development, growth and expansion of our business, our intent, belief or current expectations, primarily with respect to our future operating performance and the products we expect to offer, and other statements regarding matters that are not historical facts, are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act, and are subject to the safe harbor created by these sections. Because such forward-looking statements are subject to risks and uncertainties, many of which are beyond our control, actual results may differ materially from those expressed or implied by such forward-looking statements. Some of the factors that could cause actual results to differ materially from those expressed or implied by such forward-looking statements can be found in Part II, Item 1A, Risk Factors and in our reports filed with the Securities and Exchange Commission, or SEC, including our Annual Report on Form 10-K for the year ended December 31, 2005. Readers are cautioned not to place undue reliance on forward-looking statements. The forward- looking statements speak only as of the date on which they are made, and we undertake no obligation to update such statements to reflect events that occur or circumstances that exist after the date on which they are made.

The following discussion of our financial condition and results of operations should be read in conjunction with our condensed consolidated financial statements and notes thereto included elsewhere in this quarterly report on Form 10-Q and our consolidated financial statements and notes thereto included in our annual report on Form 10-K for the year ended December 31, 2005.

Overview

We are a provider of storage systems for organizations requiring high reliability, high performance networked storage and data management solutions in an open systems architecture. Our storage solutions consist of integrated hardware and software products employing a modular system that allows end-users to add capacity as needed. Our broad range of products, from medium capacity stand-alone storage units to complete turn-key, multi-terabyte storage area networks, provides end-users with a cost-effective means of addressing increasing storage demands without sacrificing performance.

Our products and services are sold worldwide to end-users primarily through our channel partners, including original equipment manufacturers, or OEMs, systems integrators, or SIs, and value added resellers, or VARs. In May 2002, we entered into a product purchase agreement with Sun Microsystems Inc., or Sun, to provide our storage hardware and software products for private label sales by Sun. That agreement has since been extended so that it expires on January 1, 2011 and now provides for automatic renewals for additional one-year periods unless either party notifies the other of its intent not to renew within a certain period of time. We have been shipping our products to Sun for resale to Sun s customers since October 2002. Since the start of the relationship, we have continued to develop new products for resale by Sun and others. Our agreement with Sun was most recently amended in September 2005 to provide for discounts for prompt payment by Sun of amounts due to us and an extended repair warranty for repaired or replacement products that we deliver to Sun. Because of the significance of our relationship with Sun, we are subject to seasonality associated with Sun s business. Typically, sales in the second quarter of our fiscal year reflect the positive impact associated with Sun s fiscal year-end. Conversely, sales in the third quarter of our fiscal year typically reflect the impact of lower Sun first quarter sales compared to the historically stronger sales of Sun s June year-end quarter. On April 25, 2006, we were informed by Sun of its decision to move potential future supply of a new, low-end, entry-level storage product to another party. The project had previously been directed solely to Dot Hill. We believe that Sun s decision to re-direct the award to another party will not impact our current SE3000 product line being sold to Sun.

On July 26, 2005, we entered into a Development and OEM Supply Agreement with Network Appliance, Inc. and Network Appliance B.V., collectively, NetApp. Under the Agreement, we will design and develop general purpose disk arrays for a variety of products to be developed for sale to NetApp. We believe that once sales under this agreement increase, which is expected to occur over the next several quarters, our revenue dependence upon Sun will be significantly reduced.

On January 28, 2006, we entered into a Master Purchase Agreement with Fujitsu Siemens Computers GmbH and Fujitsu Siemens Computers (Holding) B.V., collectively, Fujitsu. Under the agreement, Dot Hill and Fujitsu will jointly develop storage solutions utilizing key components and patented technologies from Dot Hill. We believe that once sales under this agreement commence, our revenue dependence upon Sun will be further reduced.

As part of our focus on indirect sales channels, we have outsourced substantially all of our manufacturing operations to Solectron Corporation, or Solectron, a leading electronics manufacturing services company. Our agreement with Solectron allows us to reduce sales cycle times and manufacturing infrastructure, enhance working capital and improve margins by taking advantage of Solectron s manufacturing and procurement economies of scale.

We derive a portion of our revenue from services associated with the maintenance service we provide for our installed products. In May 2003, we entered into a services agreement with Anacomp, Inc. to provide all maintenance, warranty and non-warranty services for our SANnet I and certain legacy products.

Cost of goods sold includes costs of materials, subcontractor costs, salary and related benefits for the production and service departments, depreciation and amortization of equipment used in the production and service departments, production facility rent and allocation of overhead.

Sales and marketing expenses consist primarily of salaries and commissions, advertising and promotional costs and travel expenses. Research and development expenses consist primarily of project-related expenses and salaries for employees directly engaged in research and development. General and administrative expenses consist primarily of compensation to officers and employees performing administrative functions, expenditures for administrative facilities and expenditures for legal and accounting services. Restructuring expenses consist primarily of employee severance, lease termination costs and other office closure expenses related to the consolidation of excess facilities.

Other income is comprised primarily of interest income earned on our cash, cash equivalents, and short-term investments and other miscellaneous income and expense items.

In August 1999, Box Hill Systems Corp. merged with Artecon, Inc. and we changed our name to Dot Hill Systems Corp. We reincorporated in Delaware in 2001. Our headquarters are located in Carlsbad, California, and we maintain international offices in Germany, Japan, the Netherlands, Singapore, Israel, Hungary and the United Kingdom.

On February 23, 2004, we completed the acquisition of Chaparral Network Storage, Inc., or Chaparral, a privately held developer of specialized storage appliances as well as high-performance, midrange redundant arrays of independents disks, or RAID, controllers and data routers. The total transaction cost of approximately $67.6 million consisted of a payment of approximately $62 million in cash, the assumption of approximately $4.1 million related to obligations due certain employees covered by change in control agreements, approximately $0.8 million of direct transaction costs and approximately $0.7 million of accrued integration costs. The acquisition of Chaparral is expected to enable Dot Hill to increase the amount of proprietary technology within its storage systems, broaden its product line and diversify its customer base.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and use judgment that may impact the reported amounts of assets, liabilities, revenues, expenses and related disclosure of contingent assets and liabilities. As a part of our on-going internal processes, we evaluate our estimates, including those related to inventory write-downs, warranty cost accruals, revenue recognition, bad debt allowances, long-lived assets valuation, goodwill and intangible assets valuation, income taxes, including deferred income tax asset valuation, litigation and contingencies. We base these estimates upon both historical information and other assumptions that we believe are valid and reasonable under the circumstances. These assumptions form the basis for making judgments and determining the carrying values of assets and liabilities that are not apparent from other sources. Actual results could vary from those estimates under different assumptions and conditions.

We believe that the policies set forth below may involve a higher degree of judgment and complexity in their application than our other accounting policies and represent the critical accounting policies used in the preparation of our financial statements.

Revenue Recognition

Revenues are recognized pursuant to applicable accounting standards, including SEC Staff Accounting Bulletin No. 104, *Revenue Recognition* and Statement of Position (SOP) No. 97-2, *Software Revenue Recognition.*

We recognize revenue for non-software product sales upon transfer of title to the customer. Reductions to revenue for estimated sales returns are also recorded at that time. These estimates are based on historical sales returns, changes in customer demand and other factors. If actual future returns and allowances differ from past experience, additional allowances may be required. Certain of our sales arrangements include multiple elements. Generally, these arrangements include delivery of the product, installation, training and product maintenance. Maintenance related to product sales entitles the customer to basic product support and significantly greater response time in resolving warranty related issues. We allocate revenue to each element of the arrangement based on its relative fair value. For maintenance contracts this is typically the price charged when such contracts are sold separately or renewed. Because professional services related to installation and training can be provided by other third party organizations, we allocate revenue related to professional services based on rates that are consistent with other like companies providing similar services, i.e., the market rate for such services. Revenue from product maintenance contracts is deferred and recognized ratably over the contract term, generally 12 months. Revenue from installation, training and consulting is recognized as the services are performed.

For software sales, we apply SOP No. 97-2*,* whereby revenue is recognized from software licenses at the time the product is delivered, provided there are no significant obligations related to the sale, the resulting receivable is deemed collectible and there is vendor-specific objective evidence supporting the value of the separate contract elements. For arrangements with multiple elements, we allocate revenue to each element using the residual method based on vendor specific objective evidence of the undelivered items. A portion of the arrangement fee equal to the fair value of the undelivered elements, typically software maintenance contracts, is deferred and recognized ratably over the contract term, generally 12 months. Vendor specific objective evidence is based on the price charged when the element is sold separately. A typical arrangement includes a software-licensing fee and maintenance agreement.

The cost of maintenance contracts entered into with third parties is deferred and recognized as expense over the contract term. The balance of deferred costs for maintenance contracts is included in prepaid expenses, other current assets and other long-term assets.

Valuation of Inventories

Inventories are comprised of purchased parts and assemblies, which include direct labor and overhead. We record inventories at the lower of cost or market value, with cost generally determined on a first-in, first-out basis. We perform periodic valuation assessments based on projected sales forecasts and analyzing upcoming changes in future configurations of our products and record inventory write-downs for excess and obsolete inventory. Although we strive to ensure the accuracy of our forecasts, we periodically are faced with uncertainties. The outcomes of these uncertainties are not within our control, and may not be known for prolonged periods of time. Any significant unanticipated changes in demand or technological developments could have a significant impact on the value of our inventories and commitments, and consequently, on our operating results. If actual market conditions become less favorable than those forecasted, additional inventory write-downs might be required, adversely affecting operating results.

Valuation of Goodwill

We review goodwill for impairment annually and whenever events or changes in circumstances indicate the carrying value of an asset may not be recoverable in accordance with Statement of Financial Accounting Standards, or SFAS, No. 142, *Goodwill and Other Intangible Assets.* The provisions of SFAS No. 142 require that a two-step impairment test be performed on goodwill. In the first step, we compare the fair value of each reporting unit to its carrying value. Our reporting units are consistent with the reportable segments identified in the notes to our consolidated financial statements. We determine the fair value of our reporting units using the income approach. Under the income approach, we calculate the fair value of a reporting unit based on the present value of estimated future cash flows. If the fair value of the reporting unit exceeds the carrying value of the net assets assigned to that unit, goodwill is not impaired and we are not required to perform further testing. If the carrying value of the net assets assigned to the reporting unit exceeds the fair value of the reporting unit, then we must perform the second step in order to determine the implied fair value of the reporting unit s goodwill and compare it to the carrying value of the reporting unit s goodwill. If the carrying value of a reporting unit s goodwill exceeds its implied fair value, then we must record an impairment loss equal to the difference.

The income approach is dependent on a number of factors including estimates of future market growth and trends, forecasted revenue and costs, expected periods the assets will be utilized, appropriate discount rates and other variables. We base our fair value estimates on assumptions we believe to be reasonable, but which are unpredictable and inherently uncertain. Actual future results may differ from those estimates.

Deferred Income Taxes

We account for income taxes under the asset and liability method, under which deferred tax assets, including net operating loss carryforwards, and liabilities are determined based on temporary differences between the book and tax basis of assets and liabilities. We periodically evaluate the likelihood of the realization of deferred tax assets, and adjust the carrying amount of the deferred tax assets by the valuation allowance to the extent we believe a portion will be realized. We consider many factors when assessing the likelihood of future realization of our deferred tax assets, including our recent cumulative earnings experience by taxing jurisdiction, expectations of future taxable income, the carryforward periods available to us for tax reporting purposes, and other relevant factors.

Due to our equity transactions, an ownership change, within the meaning of Internal Revenue Code, or IRC, Section 382, occurred on September 18, 2003. As a result, annual use of our federal net operating loss and credit carry forwards is limited to (i) the aggregate fair market value of Dot Hill. immediately before the ownership change multiplied by (ii) the long-term tax-exempt rate (within the meaning of IRC Section 382 (f)) in effect at that time. The annual limitation is cumulative and, therefore, if not fully utilized in a year, can be utilized in future years in addition to the IRC Section 382 limitation for those years.

As a result of our acquisition of Chaparral, a second ownership change, within the meaning of IRC Section 382, occurred on February 23, 2004. As a result, annual use of the acquired Chaparral s federal net operating loss and credit carry forwards may be limited. The annual limitation is cumulative and, therefore, if not fully utilized in a year, can be utilized in future years in addition to the IRC Section 382 limitation for those years.

At December 31, 2005, based on the weight of available evidence, including cumulative profitability in recent years, we determined that it was more likely than not that a portion of our United States deferred tax assets would be realized and, at December 31, 2005, eliminated $47.1 million of valuation allowance associated with our United States deferred tax assets. The elimination of valuation allowance resulted in a $16.4 million decrease to goodwill to the extent of our acquired net deferred tax assets, a $5.4 million increase to equity for net operating losses arising from stock option deductions, with the remaining $25.3 million recognized as a one-time non-cash increase in earnings for the year ended December 31, 2005. As a result of our elimination of valuation allowance associated with United States deferred tax assets, our effective tax rate in subsequent periods is likely to more closely resemble the applicable federal and state statutory tax rates.

Stock-Based Compensation

We account for stock-based compensation in accordance with SFAS No. 123(R), *Share-Based Payment*, which requires us to record stock compensation expense for equity based awards granted, including stock options, for which expense will be recognized over the service period of the equity based award based on the fair value of the award, at the date of grant. SFAS No. 123(R) revises SFAS No. 123, *Accounting for Stock-Based Compensation*, and supersedes Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees.*

We adopted the provisions of SFAS No. 123(R) using the modified prospective transition method. In accordance with this transition method, our consolidated financial statements for prior periods have not been restated to reflect the impact of SFAS No. 123(R). Under the modified prospective transition method, share-based compensation expense for the first quarter of 2006 includes compensation expense for all share-based compensation awards granted prior to, but for which the requisite service has not yet been performed as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123. Share-based compensation expense for all share-based compensation awards granted after January 1, 2006 is based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123(R) using the Black-Scholes option-pricing model.

On December 1, 2005, we accelerated vesting of certain unvested and out-of-the-money stock options with exercise prices equal to or greater than $6.74 per share that were previously awarded under our equity compensation plans to our employees. These options were accelerated to avoid recording future compensation expense with respect to such options following adoption of SFAS No. 123(R). Our management believes that because such options had exercise prices in excess of the current market value of our common stock, the options were not achieving their original objective. The acceleration of vesting was effective for stock options outstanding as of December 1, 2005. Options to purchase 0.6 million shares of common stock were subject to the acceleration and the weighted average exercise price of the options subject to the acceleration was $11.71. Due to this acceleration, an additional

$2.8 million was included in the pro forma stock-based compensation expense for the year ended December 31, 2005.

As of March 31, 2006, total unrecognized share-based compensation cost related to unvested stock options was $7.0 million, which is expected to be recognized over a weighted average period of approximately 2.8 years.

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Contingencies

We are subject to various legal proceedings and claims and tax matters, the outcomes of which are subject to significant uncertainty. SFAS No. 5, *Accounting for Contingencies*, requires that an estimated loss from a loss contingency should be accrued by a charge to income if it is probable that an asset has been impaired or a liability has been incurred and the amount of the loss can be reasonably estimated. Disclosure of a contingency is required if there is at least a reasonable possibility that a loss has been incurred. We evaluate, among other factors, the degree of probability of an unfavorable outcome and the ability to make a reasonable estimate of the amount of loss. Changes in these factors could materially impact our financial position or our results of operations. See Note 11 to our condensed consolidated financial statements for further information regarding contingencies.

Results of Operations

The following table sets forth certain items from our statements of operations as a percentage of net revenue for the periods indicated:

	Three Months Ended March 31,	
	2005	**2006**
Net revenue:	100.0%	100.0%
Cost of goods sold	77.1	81.0
Gross profit	22.9	19.0
Operating expenses:		
Sales and marketing	8.0	7.1
Research and development	8.1	16.5
General and administrative	4.5	10.5
Total operating expenses	20.7	34.1
Operating income (loss)	2.2	(15.1)
Other income, net	1.2	2.2
Income tax benefit	(0.2)	(4.4)
Net income (loss)	3.6%	(8.5)%

(percentages may not aggregate due to rounding)

Three Months Ended March 31, 2006 Compared to Three Months Ended March 31, 2005

Net Revenue

Net revenue increased $0.7 million, or 1.2%, to $58.7 million for the three months ended March 31, 2006 from $58.0 million for the three months ended March 31, 2005. The increase in net revenue was attributable to increased orders for our products from our channel partner, Sun, which accounted for 87.7% of our net revenue for the three months ended March 31, 2006. Fibre Channel units shipped were 2,284 for the three months ended March 31, 2006 compared to 2,789 units for the three months ended March 31, 2005. Small Computer Systems Interface, or SCSI, units shipped were 3,265 for the three months ended March 31, 2006 compared to 3,570 units for the three months ended March 31, 2005. Blade units shipped were 1,958 for the three months ended March 31, 2006 compared to 926 units for the three months ended March 31, 2005. SATA units shipped were 674 for the three months ended March 31, 2006 compared to 566 units for the three months ended March 31, 2005. Additionally, the increase in revenue is attributable to sales of pre-production units related to our new product offerings. Non-Sun revenue was $7.2 million for the three months ended March 31, 2006 compared to $8.2 million for the three months ended March 31, 2005.

Cost of Goods Sold

Cost of goods sold increased $2.8 million, or 6.3%, to $47.5 million for the three months ended March 31, 2006 from $44.7 million for the three months ended March 31, 2005. As a percentage of net revenue, cost of goods sold increased to 81.0% for the three months ended March 31, 2006 from 77.1% for the three months ended March 31, 2005. The increase in cost of goods sold was attributable to greater volume of product sales during the three months ended March 31, 2006 compared to the three months ended March 31, 2005. The increase in cost of goods sold, as a percentage of our net revenue is primarily attributable to a difference in our product mix and increased headcount.

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Gross Profit

Gross profit decreased $2.1 million, or 15.8%, to $11.2 million for the three months ended March 31, 2006 from $13.3 million for the three months ended March 31, 2005. As a percentage of net revenue, gross profit decreased to 19.0% for the three months ended March 31, 2006 from 22.9% for the three months ended March 31, 2005. The decrease in the dollar amount of gross profit is attributable to increased spending related to the product sales mix, additional headcount and consulting fees.

The decrease in gross profit as a percentage of our net revenue for the three months ended March 31, 2006 when compared to the three months ended March 31, 2005 is attributed principally to a difference in our product mix, including the transition of our largest customer from 160MB SCSI to Ultra 320 SCSI, increased headcount in operations in support of new product launches and sales of prototypes to our new OEM customers.

Sales and Marketing Expenses

Sales and marketing expenses decreased $0.5 million, or 10.6%, to $4.2 million for the three months ended March 31, 2006 from $4.7 million for the three months ended March 31, 2005. As a percentage of net revenue, sales and marketing expenses decreased to 7.1% for the three months ended March 31, 2006 from 8.0% for the three months ended March 31, 2005. The decrease in sales and marketing expenses is primarily attributable to a decrease in headcount at our subsidiaries in Japan and Europe. We expect sales and marketing expenses for the year ending December 31, 2006 will exceed spending levels incurred during 2005 due to our continued efforts to increase our market share and expand both our non-OEM commercial sales and channel partners.

Research and Development Expenses

Research and development expenses increased $5.0 million, or 106.4%, to $9.7 million for the three months ended March 31, 2006 from $4.7 million for the three months ended March 31, 2005. As a percentage of net revenue, research and development expenses increased to 16.5% for the three months ended March 31, 2006 from 8.1% for the three months ended March 31, 2005. The increase in research and development expenses is primarily due to the investment in prototypes and project materials for products under development for the company s new OEM customers of $3.7 million and payroll related expenses of $0.7 million. We expect research and development expenses for the year ending December 31, 2006 will exceed spending levels incurred during 2005 due to activities related to future product offerings.

General and Administrative Expenses

General and administrative expenses increased $3.6 million, or 138.5%, to $6.2 million for the three months ended March 31, 2006 from $2.6 million for the three months ended March 31, 2005. As a percentage of net revenue, general and administrative expenses increased to 10.5% for the three months ended March 31, 2006 from 4.5% for the three months ended March 31, 2005. The increase is primarily attributable to $1.3 million of expenses associated with the acceleration of vesting of stock options of our former chief executive officer and his consulting agreement, legal expense of $0.8 million, stock option expense and employee stock purchase plan expense of $0.2 million related to the adoption of SFAS No. 123(R), implementation expenses related to our new enterprise resource planning, or ERP, software package, which became operational in January 2006, of $0.2 million, and consulting expenses related to the compliance with the Sarbanes-Oxley Act of 2002 of $0.2 million.

Other Income

Other income increased by $0.6 million, or 85.7%, to $1.3 million for the three months ended March 31, 2006 from $0.7 million for the three months ended March 31, 2005. The increase was primarily attributable to an increase in interest income of $0.6 million due to rising interest rates.

Income Taxes

We recorded an income tax benefit of $2.6 million for the three months ended March 31, 2006 attributable to the net loss for the three months ended March 31, 2006. Our effective income tax rate of 34.1% for the three months ended March 31, 2006 differs from the US federal statutory rate due to our valuation allowance against operations taxed in foreign jurisdictions, state taxes, and the impact of share based compensation expense recognized under SFAS 123(R). At March 31, 2005, we recorded a tax benefit of $0.1 million, reflecting an effective tax rate of (5.6%). Our effective tax rate for the three months ended March 31, 2005 differs from the US federal statutory rate primarily due to our US and foreign valuation

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allowance position, federal and state minimum tax, and a discrete tax benefit of $0.2 million associated with the receipt by our European subsidiary of $0.2 million from European taxing authorities related to a 2002 loss that was carried back to the years 1998 through 2001.

As of December 31, 2005, a valuation allowance of $3.6 million has been provided for our foreign deferred tax assets based upon our assessment of the future realizability of certain foreign deferred tax assets, as it is more likely than not that sufficient taxable income will not be generated to realize these deferred tax assets.

As of December 31, 2005, we have federal and state net operating losses of approximately $113.1 million and $49.0 million, which begin to expire in the tax years ending 2009 and 2006, respectively. In addition, we have federal tax credit carryforwards of $2.9 million, of which $0.5 million can be carried forward indefinitely to offset future taxable income, and the remaining $2.4 million will begin to expire in the tax year ending 2008. We also have state tax credit carryforwards of $3.1 million, of which $2.9 million can be carried forward indefinitely to offset future taxable income, and the remaining $0.2 million will begin to expire in the tax year ending 2006.

As a result of our equity transactions, an ownership change, within the meaning of IRC Section 382, occurred on September 18, 2003. As a result, annual use of our federal net operating loss and credit carry forwards is limited to (i) the aggregate fair market value of Dot Hill immediately before the ownership change multiplied by (ii) the long-term tax-exempt rate (within the meaning of IRC Section 382 (f)) in effect at that time. The annual limitation is cumulative and, therefore, if not fully utilized in a year, can be utilized in future years in addition to the IRC Section 382 limitation for those years.

We have not provided for any residual U.S. income taxes on the earnings from our foreign subsidiaries because such earnings are intended to be indefinitely reinvested. Such residual U.S. income taxes, if any, would be insignificant.

Liquidity and Capital Resources

As of March 31, 2006, we had $114.8 million of cash, cash equivalents and short-term investments. We had $130.1 million of working capital as of March 31, 2006.

For the three months ended March 31, 2006, cash used in operating activities was $6.8 million compared to cash used in operating activities of $2.0 million for the same period in 2005. The net cash used in operating activities for the three months ended March 31, 2006 is primarily attributable to a net loss $5.0 million, an increase in accounts receivable of $10.2 million primarily due from Sun, an increase in our deferred tax assets of $2.6 million, a decrease in deferred revenue of $0.9 million, and an increase in prepaid expenses and other assets of $0.6 million. These amounts were offset by depreciation and amortization of $1.7 million, stock option expense related to the acceleration of our former chief executive officer s stock options of $0.7 million, stock option expense of $0.3 million and employee stock purchase plan expense of $0.2 million attributable to the adoption of SFAS No. 123(R), an increase in accounts payable of $7.5 million primarily due to Solectron, and an increase in other long-term liabilities of $1.4 million primarily attributable to deferred rent related to our new corporate headquarters.

Cash used in investing activities for the three months ended March 31, 2006 was $2.7 million compared to $21.5 million for the same period in 2005. The cash used in the three months ended March 31, 2006 is attributable to purchases related to our new corporate headquarters and machinery and equipment of $1.6 million, and purchases of short-term investments of $8.9 million, offset by the proceeds received from the maturity of short-term investments of $7.8 million.

Cash provided by financing activities for the three months ended March 31, 2006 was $1.0 million compared to cash provided by financing activities of $0.7 million for same period in 2005. The cash provided by financing activities is attributable to the proceeds received from the exercises of stock options under our equity incentive plans and warrants of $0.4 million and the proceeds received from the sale of common stock to employees under our employee stock purchase plan of $0.6 million.

We presently expect cash, cash equivalents, short-term investments and cash generated from operations to be sufficient to meet our operating and capital requirements for at least the next 12 months and to enable us to pursue acquisitions or significant capital improvements. The actual amount and timing of working capital and capital expenditures that we may incur in future periods may vary significantly and will depend upon numerous factors, including the amount and timing of the receipt of revenues from continued operations, our ability to manage our relationships with third party manufacturers, the status of our relationships with key customers, partners and suppliers, the timing and extent of the introduction of new products and services and growth in personnel and operations.

Recent Accounting Pronouncements

In May 2005, the Financial Accounting Standards Board, or FASB, issued Statement No. 154, *Accounting Changes and Error Corrections,* which requires retrospective application to prior periods financial statements of a voluntary change in accounting principle and that a change in method of depreciation, amortization, or depletion for long-lived, nonfinancial assets be accounted for as a change in accounting estimate that is effected by a change in accounting principle. Statement No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005.

In June 2005, the FASB issued Staff Position (FSP) No. 143-1, *Accounting for Electronic Equipment Waste Obligations*, which provides guidance on the accounting for obligations associated with the Directive on Waste Electrical and Electronic Equipment, or the WEEE Directive, which was adopted by the European Union. FSP No. 143-1 provides guidance on accounting for the effects of the WEEE Directive with respect to historical waste and waste associated with products on the market on or before August 13, 2005. FSP No. 143-1 requires commercial users to account for their WEEE obligation as an asset retirement liability in accordance with FASB Statement No. 143, *Accounting for Asset Retirement Obligations.* FSP No. 143-1 was required to be applied to the later of the first reporting period ending after June 8, 2005 or the date of the adoption of the WEEE Directive into law by the applicable European Union member country. The WEEE Directive has been adopted into law by the majority of European Union member countries in which we have significant operations. We adopted the provisions of FSP 143-1 as it relates to these countries with no material impact on its financial statements. We will apply the guidance of FSP No. 143-1 as it relates to the remaining European Union member countries in we operate when those countries have adopted the WEEE Directive into law. The effect of applying FSP No. 143-1 in the remaining countries in future periods is not expected to have a material effect on our results of operations or financial condition.

On February 23, 2006, the FASB issued FSP No. FAS 123(R)-4, *Classification of Options or Similar Instruments Issued as Employee Compensation That Allow for Cash Settlement Upon the Occurrence of a Contingent Event*. FSP No. FAS 123(R)-4 requires that an award of stock options or similar instruments that otherwise meet the criteria for equity classification, but contains a cash settlement feature that can require the entity to settle the award in cash only upon the occurrence of a contingent event that is outside the employee s control, should be classified as a liability only when the event is probable of occurring. FSP No. FAS 123(R)-4 is effective for our first reporting period beginning after February 3, 2006. We do not believe that the adoption of FSP No. FAS 123(R)-4 will have a material effect on our results of operations or financial condition.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Interest Rate and Credit Risk

Our exposure to market rate risk for changes in interest rates relates to our investment portfolio. Our primary investment strategy is to preserve the principal amounts invested, maximize investment yields, and maintain liquidity to meet projected cash requirements. Accordingly, we invest in instruments such as money market funds, certificates of deposit, United States government/agencies bonds, notes, bills and municipal bonds that meet high credit quality standards, as specified in our investment policy guidelines. Our investment policy also limits the amount of credit exposure to any one issue, issuer, and type of instrument. We do not currently use derivative financial instruments in our investment portfolio and we do not enter into market risk sensitive instruments for trading purposes. We do not expect to incur any material losses with respect to our investment portfolio.

The following table provides information about our investment portfolio at December 31, 2005 and March 31, 2006. For investment securities, the table presents carrying values at December 31, 2005 and March 31, 2006 and, as applicable, and related weighted average interest rates by expected maturity dates.

	December 31, 2005	March 31, 2006
	(amounts in thousands)	
Cash equivalents	$ 99,899	$ 94,061
Average interest rate	4.3%	4.6%
Short-term investments	$ 13,431	$ 14,535

Average interest rate	3.2%	4.2%
Total portfolio	$113,330	$ 108,596
Average interest rate	4.2%	4.7%

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We have a line of credit agreement, which accrues interest at a variable rate. As of March 31, 2006, we had no balance under this line. Were we to incur a balance under this line of credit, we would be exposed to interest rate risk on such debt.

Foreign Currency Exchange Rate Risk

A portion of our international business is presently conducted in currencies other than the United States dollar. Foreign currency transaction gains and losses arising from normal business operations are credited to or charged against earnings in the period incurred. As a result, fluctuations in the value of the currencies in which we conduct our business relative to the United States dollar will cause currency transaction gains and losses, which we have experienced in the past and continue to experience. Due to the substantial volatility of currency exchange rates, among other factors, we cannot predict the effect of exchange rate fluctuations upon future operating results. There can be no assurances that we will not experience currency losses in the future. We have not previously undertaken hedging transactions to cover currency exposure and we do not intend to engage in hedging activities in the future.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

We conducted an evaluation, under the supervision and with the participation of our management, including our chief executive officer and interim chief financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)), as of March 31, 2006. Based upon that evaluation, the chief executive officer and the interim chief financial officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this quarterly report on Form 10-Q.

Changes in Internal Controls

An evaluation was also performed under the supervision and with the participation of our management, including our chief executive officer and our interim chief financial officer, of any change in our internal control over financial reporting that occurred during our last quarter and that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting. During the three months ended March 31, 2006, we implemented a new ERP software package. While we have not finalized the documentation or performed testing of the related internal controls, we believe the implementation of our new ERP system has improved and will improve our internal controls over financial reporting by increasing the availability of data used in the financial closing process and through simplifying our closing process by decreasing the amount of manual processes previously required by our previous system. While we have not finalized the documentation or performed testing of the related internal controls, we believe the implementation of our new ERP system also has improved and will improve our internal control over inventory processing for the same reasons. Except as described above, the evaluation concluded that there has been no change in our internal control over financial reporting that occurred during the quarter covered by this quarterly report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Our management, including our chief executive officer and our interim chief financial officer, does not expect that our disclosure controls will prevent all errors or potential fraud. A control system, no matter how well conceived and operated, can provide only reasonable and not absolute assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their cost. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within our company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons or by collusion of two or more people. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, control may become inadequate because of changes in conditions, or the degree of compliance with policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

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Part II. Other Information

Item 1. Legal Proceedings

Crossroads Systems Litigation

On October 17, 2003, Crossroads Systems, Inc., or Crossroads, filed a lawsuit against us in the United States District Court in Austin, Texas, alleging that our products infringe two United States patents assigned to Crossroads, Patent Numbers 5,941,972 and 6,425,035. We were served with the lawsuit on October 27, 2003. Chaparral was added as a party to the lawsuit in March 2004. The patents involve storage routers and methods for providing virtual local storage. Patent Number 5,941,972 involves the interface of SCSI storage devices and the Fibre Channel protocol and Patent Number 6,425,035 involves the interface of any one-transport medium and a second transport medium. We believe that we have meritorious defenses to Crossroads claims and are in the process of vigorously defending against them. The outcome is uncertain and no amounts have been accrued as of March 31, 2006. However, we expect to incur significant legal expenses in connection with this litigation. These defense costs, and other expenses related to this litigation, will be expensed as incurred and will negatively affect our operating results. A trial in the matter is expected to commence on June 5, 2006.

Chaparral Securities Class Action

In August 2004, a class action lawsuit was filed against, among others, Chaparral and a number of its former officers and directors in the United States District Court for the Central District of California. The lawsuit, among other things, alleges violations of federal and state securities laws and purports to seek damages on behalf of a class of shareholders who held interests in limited liability companies that had purchased, among other securities, Chaparral stock during a defined period prior to our acquisition of Chaparral. In May 2005, the Second Amended Complaint was dismissed with leave to amend. Plaintiffs filed a Third Amended Complaint, which the Court again dismissed with leave to amend in November of 2005 as to Chaparral and certain other defendants. Plaintiffs declined to amend within the proscribed period, and final judgment was entered in February 2006. Plaintiffs filed a notice appeal in the United States District Court of Appeals for the Ninth Circuit, though they have not filed their opening papers.

Plaintiffs filed a related action in the Superior Court of the State of California, Orange County, in December of 2005, alleging many of the same claims. That action has been stayed pending the outcome of the federal appeal. We believe that the claims against Chaparral and its former officers and directors are without merit and are in the process of vigorously defending against them. The outcome is uncertain and no amounts have been accrued as of March 31, 2006.

Dot Hill Securities Class Actions and Derivative Suits

In late January and early February 2006, numerous purported class action complaints were filed against us in the United States District Court for the Southern District of California. The complaints allege violations of federal securities laws related to alleged inflation in our stock price in connection with various statements and alleged omissions to the public and to the securities markets and declines in our stock price in connection with the restatement of certain of our quarterly financial statements for fiscal year 2004, and seeking damages therefore. The court should approve a lead plaintiff(s) and approve lead counsel within the next 30 days. After the lead plaintiff files a consolidated class action complaint, or a consolidated complaint, we will move to dismiss the consolidated complaint.

In addition, three complaints purporting to be derivative actions have been filed in California state court against certain of our directors and executive officers. These complaints are based on the same facts and circumstances described in the federal class action complaints and generally allege that the named directors and officers breached their fiduciary duties by failing to oversee adequately our financial reporting. Each of the complaints generally seeks an unspecified amount of damages. The cases are in the very preliminary stages. We believe the allegations against us and certain of our directors and executive officers in this action are without merit and we intend to vigorously defend against these claims. We are seeking dismissal of each derivative action by demurring to the complaints. The outcome is uncertain and no amounts have been accrued as of March 31, 2006.

Other Litigation

In addition to the actions discussed above, we are subject to various legal proceedings and claims, asserted or unasserted, which arise in the ordinary course of business. The outcome of the claims against us cannot be predicted with certainty. We believe that such litigation and claims will not have a material adverse effect on our financial condition or operating results.

Item 1A. Risk Factors

The following sets forth risk factors that may affect our future results, including certain revisions to the risk factors included in our annual report on Form 10-K for the fiscal year ended December 31, 2005. Our business, results of operations and financial condition may be materially and adversely affected due to any of the following risks. The risks described below are not the only ones we face. Additional risks we are not presently aware of or that we currently believe are immaterial may also impair our business operations. The trading price of our common stock could decline due to any of these risks. In assessing these risks, you should also refer to the other information contained or incorporated by reference in this quarterly report on Form 10-Q, including our financial statements and related notes.

Under our OEM agreements with Sun, NetApp and others, our customers are not required to make minimum purchases or purchase exclusively from us, and we cannot assure you that our relationship with these key customers will not be terminated or will generate significant sales.

Our business is highly dependent on our relationship with Sun, and we believe will be dependent, in the future, on our relationship with NetApp, once sales to that customer begin to increase. Sales to Sun accounted for 86.2% and 87.7% of our net revenue for the year ended December 31, 2005 and the three months ended March 31, 2006, respectively. Our OEM agreement with Sun had an initial term of three years and was extended in September 2005 for an additional five years through January 2011. Our OEM agreement with NetApp has a term of three years from the first commercial product shipments by NetApp, which is currently scheduled for the second half of 2006. There are no minimum purchase requirements or guarantees in our agreement with Sun or NetApp, the agreements do not obligate those customers to purchase storage solutions exclusively from us on a continual basis and either customer may cancel purchase orders submitted under the agreement at any time. Further, either customer may terminate the entire contract prior to the contract expiration date upon the occurrence of certain events that are not remedied within a specified cure period. The decision by these customers to terminate their respective contracts, to cease making purchases or to cancel purchase orders would cause our revenues to decline substantially. We cannot be certain if, when or to what extent any customer might cancel purchase orders, cease making purchases or elect not to renew the applicable contract upon the expiration of the current term. For example, on April 25, 2006, we were informed by Sun of its decision to move potential future supply of a new, low-end, entry-level storage product to another party. The project had previously been directed solely to Dot Hill. We expect to receive a substantial majority of our projected net revenue for the year ended December 31, 2006 from sales of our products to Sun and NetApp. We cannot assure you that we will achieve these expected sales levels. If we do not achieve the sales levels we expect to receive from these customers, our business and result of operations will be significantly harmed.

Any decline in Sun s or NetApp s sales could harm our business.

A substantial majority of our revenues are generated by sales to Sun, and we expect a substantial majority of our future revenues to be generated by a combination of sales to Sun and NetApp. If Sun s or NetApp s storage-related sales decline, our revenues will also decline and our business could be materially harmed. In addition, Sun s quarterly operating results typically fluctuate downward in the first quarter of their fiscal year when compared with the immediately preceding fourth quarter. Further, in June 2005, Sun acquired StorageTek, which is a fellow provider of storage systems. Additionally, Sun purchases products from Engenio Information Technologies, Inc., or Engenio. During October 2004, Engenio announced that it had broadened its OEM agreement with Sun. Under terms of the expanded agreement, Engenio will provide Sun with new modular storage technology and will co-develop future Sun storage products. While we do not currently believe that Engenio s relationship with Sun or Sun s acquisition of StorageTek will impact our sales or our relationship with Sun, we cannot predict with certainty the impact that these circumstances will have, if any, on our future sales to Sun.

In addition, it is likely that NetApp s sales of any storage products supplied to it by us will fluctuate on a quarterly or seasonal basis, which fluctuations will affect our financial results. Due to the infancy of the relationship, we can not be certain of what affect these fluctuations will have on our quarterly results, if any.

Lower than anticipated sales to NetApp could harm our business and render our expectations inaccurate, which could lead to a decrease in our stock price.

During the third quarter of 2005, we entered into a Development and OEM Supply Agreement with NetApp pursuant to which we will design and develop general purpose disk arrays for a variety of products to be developed for sale to NetApp. We expect that sales to NetApp will increase, and have predicted that in the future, sales to NetApp will reduce our dependence upon Sun significantly and increase our revenue substantially. There are no guarantees that our relationship with NetApp will be successful, or that we will achieve the expected volume of sales to NetApp. Our agreement with NetApp does not provide for minimum purchase quantities, and allows NetApp to terminate the contract or stop purchasing from us upon the occurrence of certain events. If our sales to NetApp fall substantially short of our predictions, to the extent that our current stock price reflects anticipated increases in our revenue or profits based on sales to NetApp, our stock price likely will fall.

We are dependent on sales to a relatively small number of customers.

While we intend to expand sales to channel partners, we expect to experience continued concentration in our customer base. As a result, if our relationship with any of our customers were disrupted, we would lose a significant portion of our anticipated net revenue. We cannot guarantee that our relationship with Sun, NetApp or other channel partners will expand or not otherwise be disrupted. Factors that could influence our relationship with significant channel partners, including Sun and NetApp, include:

- our ability to maintain our products at prices that are competitive with those of other storage system suppliers;
- our ability to maintain quality standards for our products sufficient to meet the expectations of our channel partners; and
- our ability to produce, ship and deliver a sufficient quantity of our products in a timely manner to meet the needs of our channel partners.

None of our contracts with our existing channel partners, including Sun and NetApp, contain any minimum purchasing commitments. Further, we do not expect that future contracts with channel partners, if any, will include any minimum purchasing commitments. Changes in the timing or volume of purchases by our major customers could result in lower revenue. In addition, our existing contracts do not require our channel partners to purchase our products exclusively or on a preferential basis over the products of any of our competitors. Consequently, our channel partners may sell the products of our competitors. For example, on April 25, 2006, we were informed by Sun of its decision to move potential future supply of a new, low-end, entry-level storage product to another party. The project had previously been directed solely to Dot Hill.

Our business and operating results may suffer if we encounter significant product defects due to the introduction of our new, integrated systems.

We completed the integration of RAID controller technology we obtained in our acquisition of Chaparral into certain of our storage systems resulting in the introduction of new, integrated systems.

Our new, integrated systems, as well as our legacy products, may contain undetected errors or failures, which may be discovered after shipment, resulting in a loss of revenue or a loss or delay in market acceptance, which could harm our business. Even if the errors are detected before shipment, such errors could result in the halting of production, the delay of shipments, loss of goodwill, tarnishment of reputation or a substantial decrease in revenue. Our standard warranty provides that if our systems do not function to published specifications, we will repair or replace the defective component or system without charge. Significant warranty costs, particularly those that exceed reserves, could adversely impact our business. In addition, defects in our products could result in our customers claiming property damages, consequential damages, personal injury or even death, which could also result in our loss of customers and goodwill. Any such claim could distract management s attention from operating our business and, if successful, result in damage claims against us that might not be covered by our insurance.

The loss of one or more suppliers could slow or interrupt the production and sales of our products.

Solectron, our third party manufacturer, relies on third parties to supply key components of our storage products. Many of these components are available only from limited sources in the quantities and quality we require. Solectron purchases the majority of our RAID controllers from Infortrend Technology, Inc., or Infortrend. Solectron may not be able to purchase the type or quantity of components from third party suppliers as needed in the future.

From time to time there is significant market demand for disk drives, RAID controllers and other components, and we may experience component shortages, selective supply allocations and increased prices of such components. In such event, we may be required to purchase our components from alternative suppliers. Even if alternative sources of supply for critical components such as disk drives and controllers become available, incorporating substitute components into our products could delay our ability to deliver our products in a timely manner. For example, we estimate that replacing Infortrend s RAID controllers with those of another supplier would involve several months of hardware and software modification, which could significantly harm our ability to meet our customers orders for our products, damage our customer relationships and result in a loss of sales.

Manufacturing disruptions could harm our business.

We rely on Solectron to manufacture substantially all of our products. If our agreement with Solectron is terminated or if Solectron does not perform its obligations under our agreement, it could take several months to establish alternative manufacturing for our products and we may not be able to fulfill our customers orders in a timely manner. Under our OEM agreement with Sun, Sun has the right to require that we use a third party to manufacture our products. Such an external manufacturer must meet Sun s engineering, qualification and logistics requirements. If our agreement with Solectron terminates, we may be unable to find another external manufacturer that meets Sun s requirements. With our increased use of third-party manufacturers, our ability to control the timing of shipments has continued and will continue to decrease. Delayed shipment could result in the deferral or cancellation of purchases of our products. Any significant deferral or cancellation of these sales would harm our results of operations in any particular quarter. Net revenue for a period may be lower than predicted if large orders forecasted for that period are delayed or are not realized, which could result in cash flow problems or a decline in our stock price.

Any shortage of disk drives or other components could increase our costs or harm our ability to manufacture and deliver our storage products to our customers in a timely manner.

Demand for disk drives recently surpassed supply, forcing drive manufacturers, including those who supply the disk drives integrated into many of our storage products, to manage allocation of their inventory. If this shortage is prolonged, we may be forced to pay higher prices for disk drives or may be unable to purchase sufficient quantities of disk drives to meet our customers demand for our storage products in a timely manner or at all. Similar circumstances could occur with respect to other necessary components.

We may experience losses in the future.

For the years ended December 31, 2005, 2004 and 2003 we recorded net income of $26.6 million, $11.6 million and $12.1 million, respectively; however, for the years ended December 31, 2002 and 2001, we incurred net losses of $34.3 million and $43.4 million, respectively. Further, our latest forecast predicts that we will incur a loss for 2006, fueled, in part, by an increased investment in research and development and significant legal fees associated with our current legal matters. We cannot assure you that we will be profitable in any future period. Our future capital requirements will depend on, and could increase substantially as a result of, many factors, including:

- our plans to maintain and enhance our engineering, research, development and product testing programs;
- the success of our manufacturing strategy;
- the success of our sales and marketing efforts;
- the extent and terms of any development, marketing or other arrangements;
- changes in economic, regulatory or competitive conditions; and
- costs of filing, prosecuting, defending and enforcing intellectual property rights.

Our available cash, cash equivalents, and short-term investments as of March 31, 2006 totaled $114.8 million. We presently expect cash, cash equivalents, short-term investments and cash generated from operations to be sufficient to meet our operating and capital requirements through at least the next 12 months. However, unanticipated events, such as Sun s or NetApp s failure to meet its product purchase forecast or extraordinary expenses or operating expenses in excess of our projections, may require us to raise additional funds. We may not be able to raise additional funds on commercially reasonable terms or at all. Any sales of our debt or equity securities in the future may have a substantial dilutive effect on our existing stockholders. If we are able to borrow funds, we may be required to grant liens on our assets to the provider of any source of financing or enter into operating, debt service or working capital covenants with any provider of financing that could hinder our ability to operate our business in accordance with our plans. As a result, our ability to borrow money on a secured basis may be impaired, and we may not be able to issue secured debt on commercially reasonable terms or at all.

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Our quarterly operating results have fluctuated significantly in the past and are not a good indicator of future performance.

Our quarterly operating results have fluctuated significantly in the past as shown in the following table and are not a good indicator of future performance (in millions).

Quarter	Net Revenue	Net Income (Loss)
First Quarter 2002	$ 10.9	$ (6.2)
Second Quarter 2002	11.2	(8.9)
Third Quarter 2002	8.6	(7.3)
Fourth Quarter 2002	16.3	(11.9)
First Quarter 2003	30.5	(1.5)
Second Quarter 2003	48.4	2.6
Third Quarter 2003	51.0	4.3
Fourth Quarter 2003	57.5	6.6
First Quarter 2004	47.9	(2.6)
Second Quarter 2004	69.0	6.7
Third Quarter 2004	57.0	3.5
Fourth Quarter 2004	65.5	4.0
First Quarter 2005	58.0	2.1
Second Quarter 2005	65.9	3.3
Third Quarter 2005	53.6	(1.3)
Fourth Quarter 2005*	56.3	22.5
First Quarter 2006	58.7	(5.0)

* Includes deferred tax benefit from reversal of valuation allowance of $25.3 million.

In addition, the announcement of financial results that fall short of the results anticipated by the public markets could have an immediate and significant negative effect on the trading price of our common stock in any given period.

We may have difficulty predicting future operating results due to both internal and external factors affecting our business and operations, which could cause our stock price to decline.

Our operating results may vary significantly in the future depending on a number of factors, many of which are out of our control, including:

- the size, timing, cancellation or rescheduling of significant orders;
- the cost of litigation and settlements involving intellectual property and other issues;
- product configuration, mix and quality issues;
- market acceptance of our new products and product enhancements and new product announcements or introductions by our competitors;
- manufacturing costs;

deferrals of customer orders in anticipation of new products or product enhancements;

changes in pricing by us or our competitors;

our ability to develop, introduce and market new products and product enhancements on a timely basis;

hardware component costs and availability, particularly with respect to hardware components obtained from Infortrend, a sole-source provider;

our success in creating brand awareness and in expanding our sales and marketing programs;

the level of competition;

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potential reductions in inventories held by channel partners;

slowing sales of the products of our channel partners;

technological changes in the open systems storage market;

levels of expenditures on research, engineering and product development;

changes in our business strategies;

personnel changes; and

general economic trends and other factors.

If our customers delay or cancel orders or return products, our results of operations could be harmed.

We generally do not enter into long-term purchase contracts with customers, and customers usually have the right to extend or delay shipment of their orders, return products and cancel orders. As a result, sales in any period are generally dependent on orders booked and shipped in that period. Delays in shipment orders, product returns and order cancellations in excess of the levels we expect would harm our results of operations.

Our sales cycle varies substantially and future net revenue in any period may be lower than our historical revenues or forecasts.

Our sales are difficult to forecast because the open systems storage market is rapidly evolving and our sales cycle varies substantially from customer to customer. Customer orders for our products can range in value from a few thousand dollars to over a million dollars. The length of time between initial contact with a potential customer and the sale of our product may last from six to 24 months. This is particularly true during times of economic slowdown, for sales to channel partners and for the sale and installation of complex solutions. We have shifted our business strategy to focus primarily on channel partners, with whom sales cycles are generally lengthier, more costly and less certain than direct sales to end-users.

Additional factors that may extend our sales cycle, particularly orders for new products, include:

the amount of time needed for technical evaluations by customers;

customers budget constraints and changes to customers budgets during the course of the sales cycle;

customers internal review and testing procedures; and

our engineering work necessary to integrate a storage solution with a customer s system.

Our net revenue is difficult for us to predict since it is directly affected by the timing of large orders. Due to the unpredictable timing of customer orders, we may ship products representing a significant portion of our net sales for a quarter during the last month of that quarter. In addition, our expense levels are based, in part, on our expectations as to future sales. As a result, if sales levels are below expectations, our operating results may be disproportionately affected. We cannot assure you that we will experience sales growth in future periods.

The market for our products is subject to substantial pricing pressure that may decrease our margins.

Pricing pressures exist in the data storage market and have harmed and may, in the future, continue to harm our net revenue and earnings. These pricing pressures are due, in part, to continuing decreases in component prices, such as those of disks and RAID controllers. Decreases in component prices are customarily passed on to customers by storage companies through a continuing decrease in the price of storage hardware systems. In addition, because we expect to continue to make most of our sales to a small number of customers, we are subject to continued pricing pressures from our customers, particularly our OEM customers. Pricing pressures are also due, in part, to the current difficult economic conditions, which have led many companies in our industry to pursue a strategy of decreasing prices in order to win sales, the narrowing of functional differences among competitors, which forces companies to compete on price as opposed to features of products, and the introduction of new technologies, which leaves older technology more vulnerable to pricing pressures. To the extent we are unable to offset those pressures with commensurate cost reductions from our suppliers or by providing new products and features, our margins will be harmed.

Our success depends significantly upon our ability to protect our intellectual property and to avoid infringing the intellectual property of third parties, which has already resulted in costly, time-consuming litigation and could result in the inability to offer certain products.

We rely primarily on patents, copyrights, trademarks, trade secrets, nondisclosure agreements and common law to protect our intellectual property. For example, we have registered trademarks for SANnet, SANpath®, SANscape®, Stratis®, Dot Hill®, Dot Hill Systems® and the Dot Hill logo. Despite our efforts to protect our intellectual property, unauthorized parties may attempt to copy aspects of our products or obtain and use information that we regard as proprietary. In addition, the laws of foreign countries may not adequately protect our intellectual property rights. Our efforts to protect our intellectual property from third party discovery and infringement may be insufficient and third parties may independently develop technologies similar to ours, duplicate our products or design around our patents.

On October 17, 2003, Crossroads Systems filed a lawsuit against us in the United States District Court in Austin, Texas alleging that our products infringe two United States patents assigned to Crossroads, Patent Numbers 5,941,972 and 6,425,035. We were served with the lawsuit on October 27, 2003. In March 2004, Chaparral was added as a party to the lawsuit. The patents involve storage routers and methods for providing virtual local storage. Patent Number 5,941,972 involves the interface of SCSI storage devices and the Fibre Channel protocol and Patent Number 6,425,035 involves the interface of any one transport medium and a second transport medium. We believe that we have meritorious defenses to Crossroads claims and intend to vigorously defend against them. A trial in the matter is expected to commence on June 5, 2006. We have already incurred, and expect to continue to incur, significant legal expenses in connection with this litigation. These defense costs, and other expenses related to this litigation, will be expensed as incurred and will negatively affect our future operating results. If we are not successful in our defense of Crossroads claims, we may be required to pay significant amounts in the form of damages for past infringement. We also could be required to pay significant amounts in the form of licensing fees to allow us to continue to market certain products in the future, or Crossroads may deny us a license, which could lead to our inability to offer certain features on our products thereby rendering them less desirable or even unmarketable, or we may be denied the ability to distribute the product in any form. Further, other third parties may assert additional infringement claims against us in the future, which would similarly require us to incur substantial license fees, legal fees and other expenses, and distract management from the operations of our business.

We expect that providers of storage products will increasingly be subject to infringement claims as the number of products and competitors increases. In addition to the formal claims brought against us by Crossroads, we receive, from time to time, letters from third parties suggesting that we may require a license from such third parties to manufacture or sell our products. We evaluate all such communications to assess whether to seek a license from the patent owner. We may be required to purchase licenses that could have a material impact on our business, or, we may not be able to obtain the necessary license from a third party on commercially reasonable terms, or at all.

Consequently, we could be prohibited from marketing products that incorporate the protected technology or incur substantial costs to redesign our products in a manner to avoid infringement of third party intellectual property rights.

The market for storage systems is intensely competitive and our results of operations, pricing and business could be harmed if we fail to maintain or expand our market position.

The storage market is intensely competitive and is characterized by rapidly changing technology. We compete primarily against independent storage system suppliers, including EMC, Hitachi, Engenio, and Xyratex.

Many of our existing and potential competitors have longer operating histories, greater name recognition and substantially greater financial, technical, sales, marketing and other resources than us. As a result, they may have more advanced technology, larger distribution channels, stronger brand names, better customer service and access to more customers than we do. Other large companies with significant resources could become direct competitors, either through acquiring a competitor or through internal efforts. Additionally, a number of new, privately held companies are currently attempting to enter the storage market, some of which may become significant competitors in the future. Any of these existing or potential competitors may be able to respond more quickly to new or emerging technologies and changes in customer requirements, devote greater resources to the development, promotion and sale of products or deliver competitive products at lower prices than us.

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We could also lose current or future business to any of our suppliers or manufacturers, some of which directly and indirectly compete with us. Currently, we leverage our supply and manufacturing relationships to provide a significant share of our products. Our suppliers and manufacturers are very familiar with the specific attributes of our products and may be able to provide our customers with similar products. We also expect that competition will increase as a result of industry consolidation and the creation of companies with new, innovative product offerings. For example, on June 2, 2005, Sun purchased StorageTek. Current and potential competitors have established or may establish cooperative relationships among themselves or with third parties to increase the ability of their products to address the needs of our prospective customers. Accordingly, it is possible that new competitors or alliances among competitors may emerge and rapidly acquire significant market share. Increased competition is likely to result in price reductions, reduced operating margins and potential loss of market share, any of which could harm our business. We believe that the principal competitive factors affecting the storage systems market include:

- product performance, features, scalability and reliability;
- price;
- product breadth;
- timeliness of new product introductions; and
- interoperability and ease of management.

We cannot assure you that we will be able to successfully incorporate these factors into our products and compete against current or future competitors or that competitive pressures we face will not harm our business. If we are unable to develop and market products to compete with the products of competitors, our business will be materially and adversely affected. In addition, if major channel partners who are also competitors cease purchasing our products in order to concentrate on sales of their own products, our business will be harmed.

The open systems storage market is rapidly changing and we may be unable to keep pace with or properly prepare for the effects of those changes.

The open systems data storage market in which we operate is characterized by rapid technological change, frequent new product introductions, evolving industry standards and consolidation among our competitors, suppliers and customers. Customer preferences in this market are difficult to predict and changes in those preferences and the introduction of new products by our competitors or us could render our existing products obsolete. Our success will depend upon our ability to address the increasingly sophisticated needs of customers, to enhance existing products, and to develop and introduce on a timely basis, new competitive products, including new software and hardware, and enhancements to existing software and hardware that keep pace with technological developments and emerging industry standards. If we cannot successfully identify, manage, develop, manufacture or market product enhancements or new products, our business will be harmed. In addition, consolidation among our competitors, suppliers and customers may harm our business by increasing the resources of our competitors, reducing the number of suppliers available to us for our product components and increasing competition for customers by reducing customer-purchasing decisions.

A significant percentage of our expenses are fixed, and if we fail to generate revenues in associated periods, our operating results will be harmed.

Although we have taken a number of steps to reduce operating costs, we may have to take further measures to reduce expenses if we experience operating losses or do not achieve a stable net income. A number of factors could preclude us from successfully bringing costs and expenses in line with our net revenue, such as the fact that our expense levels are based in part on our expectations as to future sales, and that a significant percentage of our expenses are fixed, which limits our ability to reduce expenses quickly in response to any shortfalls in net revenue. As a result, if net revenue does not meet our projections, operating results may be negatively affected. We may experience shortfalls in net revenue for various reasons, including:

significant pricing pressures that occur because of declines in selling prices over the life of a product or because of increased competition;

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sudden shortages of raw materials or fabrication, test or assembly capacity constraints that lead our suppliers and manufacturers to allocate available supplies or capacity to other customers, which, in turn, may harm our ability to meet our sales obligations;

the reduction, rescheduling or cancellation of customer orders; and

our inability to market products with competitive features, or the inability to market certain products in any form, due to the patents or other intellectual property rights of third parties.

In addition, we typically plan our production and inventory levels based on internal forecasts of customer demand, which is highly unpredictable and can fluctuate substantially. From time to time, in response to anticipated long lead times to obtain inventory and materials from our outside suppliers, we may order materials in advance of anticipated customer demand. This advance ordering has continued and may result in excess inventory levels or unanticipated inventory write-downs due to expected orders that fail to materialize.

Our success depends on our ability to attract and retain key personnel.

Our performance depends in significant part on our ability to attract and retain talented senior management and other key personnel. Our key personnel include Dana Kammersgard, our Chief Executive Officer and President, Patrick Collins, our Chief Operating Officer, and Phil Davis, our Senior Vice President of Worldwide Sales and Marketing. If any of these individuals were to terminate his employment with us, we would be required to locate and hire a suitable replacement. Competition for attracting talented employees in the technology industry is intense. We may be unable to identify suitable replacements for any employees that we lose. In addition, even if we are successful in locating suitable replacements, the time and cost involved in recruiting, hiring, training and integrating new employees, particularly key employees responsible for significant portions of our operations, could harm our business by delaying our production schedule, our research and development efforts, our ability to execute on our business strategy and our client development and marketing efforts.

Many of our customer relationships are based on personal relationships between the customer and our sales representatives. If these representatives terminate their employment with us, we may be forced to expend substantial resources to attempt to retain the customers that the sales representatives serviced. Ultimately, if we were unsuccessful in retaining these customers, our net revenue would decline.

Our executive officers and directors and their affiliates own a significant percentage of our outstanding shares, which could prevent us from being acquired and adversely affect our stock price.

As of March 31, 2006, our executive officers, directors and their affiliates beneficially owned approximately 10.5% of our outstanding shares of common stock. These individual stockholders may be able to influence matters requiring approval by our stockholders, including the election of a majority of our directors. The voting power of these stockholders under certain circumstances could have the effect of delaying or preventing a change in control of us. This concentration of ownership may also make it more difficult or expensive for us to obtain financing. Further, any substantial sale of shares by these individuals could depress the market price of our common stock and impair our ability to raise capital in the future through the sale of our equity securities.

Protective provisions in our charter and bylaws and the existence of our stockholder rights plan could prevent a takeover which could harm our stockholders.

Our certificate of incorporation and bylaws contain a number of provisions that could impede a takeover or prevent us from being acquired, including, but not limited to, a classified board of directors, the elimination of our stockholders ability to take action by written consent and limitations on the ability of our stockholders to remove a director from office without cause. Our board of directors may issue additional shares of common stock or establish one or more classes or series of preferred stock with such designations, relative voting rights, dividend rates, liquidation and other rights, preferences and limitations as determined by our board of directors without stockholder approval. In addition, we adopted a stockholder rights plan in May 2003 that is designed to impede takeover transactions that are not supported by our board of directors. Each of these charter and bylaw provisions and the stockholder rights plan gives our board of directors, acting without stockholder approval, the ability to prevent, or render more difficult or costly, the completion of a takeover transaction that our stockholders might view as being in their best interests.

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The exercise of outstanding warrants may result in dilution to our stockholders.

Dilution of the per share value of our common stock could result from the exercise of outstanding warrants. As of March 31, 2006 there were outstanding warrants to purchase 1,696,081 shares of our common stock. The warrants have exercise prices ranging from $2.97 to $4.50 per share and expire at various dates through March 14, 2008. When the exercise price of the warrants is less than the trading price of our common stock, exercise of the warrants would have a dilutive effect on our stockholders. The possibility of the issuance of shares of our common stock upon exercise of the warrants could cause the trading price of our common stock to decline.

Our stock price may be highly volatile and could decline substantially and unexpectedly.

The trading price of our shares of common stock has been affected by the factors disclosed in this section as well as prevailing economic and financial trends and conditions in the public securities markets. Share prices of companies in technology-related industries, such as ours, tend to exhibit a high degree of volatility. The announcement of financial results that fall short of the results anticipated by the public markets could have an immediate and significant negative effect on the trading price of our shares in any given period. Such shortfalls may result from events that are beyond our immediate control, can be unpredictable and, since a significant proportion of our sales during each fiscal quarter tend to occur in the latter stages of the quarter, may not be discernible until the end of a financial reporting period. These factors may contribute to the volatility of the trading value of our shares regardless of our long-term prospects. The trading price of our shares may also be affected by developments, including reported financial results and fluctuations in trading prices of the shares of other publicly held companies, in our industry generally and our business segment in particular, which may not have any direct relationship with our business or prospects.

In the past, securities class action litigation has often been brought against a company following periods of volatility in the market price of its securities. For example, in late January and early February 2006, numerous purported class action complaints were filed against us in the United States District Court for the Southern District of California. The complaints allege violations of federal securities laws related to alleged inflation in our stock price in connection with various statements and alleged omissions to the public and to the securities markets and declines in our stock price in connection with the restatement of certain of our quarterly financial statements for fiscal year 2004, and seeking damages therefore. In addition, three complaints purporting to be derivative actions have been filed in California state court against certain of our directors and executive officers. These complaints are based on the same facts and circumstances described in the federal class action complaints and generally allege that the named directors and officers breached their fiduciary duties by failing to oversee adequately our financial reporting. Each of the complaints generally seeks an unspecified amount of damages. The cases are in the very preliminary stages. We believe the allegations against us and certain of our directors and executive officers in this action are without merit and we intend to vigorously defend against these claims. Securities litigation could result in the expenditure of substantial funds, divert management s attention and resources, harm our reputation in the industry and the securities markets and reduce our profitability.

Future sales of our common stock may hurt our market price.

A substantial number of shares of our common stock may become available for resale. If our stockholders sell substantial amounts of our common stock in the public market, the market price of our common stock could decline. These sales might also make it more difficult for us to sell equity securities in the future at times and prices that we deem appropriate. In addition, we are obligated to file a registration statement with respect to the resale of up to 1,394,269 shares of our common stock issuable upon exercise of warrants held by Sun.

Geopolitical military conditions, including terrorist attacks and other acts of war, may materially and adversely affect the markets on which our common stock trades, the markets in which we operate, our operations and our profitability.

Terrorist attacks and other acts of war, and any response to them, may lead to armed hostilities and such developments would likely cause instability in financial markets. Armed hostilities and terrorism may directly impact our facilities, personnel and operations that are located in the United States and internationally, as well as those of our channel partners, suppliers, third party manufacturer and customers. Furthermore, severe terrorist attacks or acts of war may result in temporary halts of commercial activity in the affected regions, and may result in reduced demand for our products. These developments could have a material adverse effect on our business and the trading price of our common stock.

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Compliance with Sarbanes-Oxley Act of 2002.

We are exposed to significant costs and risks associated with complying with increasingly stringent and complex regulation of corporate governance and disclosure standards. Changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new SEC regulations and NASDAQ Stock Market rules require growing expenditure of management time and external resources. In particular, Section 404 of the Sarbanes-Oxley Act of 2002 requires management s annual review and evaluation of our internal controls, and attestations of the effectiveness of our internal controls by our independent auditors. This process has required us to hire additional personnel and outside advisory services and has resulted in significant accounting and legal expenses. We expect to continue to incur significant expense in future periods to comply with regulations pertaining to corporate governance as described above. In addition, we have recently implemented an ERP system. This process is extremely complicated, time consuming and expensive, and while we believe the implementation was successful, it may not be sufficient to address all of our accounting system management needs.

Item 6. Exhibits

The following exhibits are included as part of this quarterly report on Form 10-Q:

Exhibit Number	**Description**
3.1	Certificate of Incorporation of Dot Hill Systems Corp. (1)
3.2	Bylaws of Dot Hill Systems Corp. (1)
4.1	Certificate of Incorporation of Dot Hill Systems Corp. (1)
4.2	Bylaws of Dot Hill Systems Corp. (1)
4.3	Form of Common Stock Certificate. (2)
4.4	Certificate of Designation of Series A Junior Participating Preferred Stock, as filed with the Secretary of State of Delaware on May 19, 2003. (3)
4.5	Form of Rights Certificate. (3)
10.1	Offer letter agreement dated February 22, 2006 between Dot Hill Systems Corp. and Patrick Collins. (4)
10.2	Consulting letter agreement effective March 1, 2006 and dated March 2, 2006 between Dot Hill Systems Corp. and James L. Lambert. (5)
10.3	Description of 2006 Executive Compensation Plan. (5)
10.4	Master Purchase Agreement effective January 13, 2006 by and among Dot Hill Systems Corp., Dot Hill Systems B.V., Fujitsu Siemens Computers GmbH and Fujitsu Siemens Computers (Holding) B.V.*
31.1	Certification pursuant to 17 CFR 240.13a-14(a) or 17 CFR 240.15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification pursuant to 17 CFR 240.13a-14(a) or 17 CFR 240.15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	

Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

Indicates management or compensatory plan or arrangement required to be identified pursuant to Item 15(b).

* Confidential treatment has been requested with respect to certain portions of this exhibit. Omitted portions have been filed separately with the SEC.

(1) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on September 19, 2001 and incorporated herein by reference.

(2) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on January 14, 2003 and incorporated herein by reference.

(3) Filed as an exhibit to our

Current Report on Form 8-K filed with the SEC on May 19, 2003 and incorporated herein by reference.

(4) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on February 24, 2006 and incorporated herein by reference.

(5) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on March 8, 2006 and incorporated herein by reference.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

	Dot Hill Systems Corp.
Date: May 10, 2006	By /s/ DANA W. KAMMERSGARD Dana W. Kammersgard *Chief Executive Officer and President* *(Principal Executive Officer)*
Date: May 10, 2006	By /s/ SHAD L. BURKE Shad L. Burke *Interim Chief Financial Officer, Vice President of Finance, Corporate Controller and Assistant Secretary (Principal Financial and Accounting Officer)*

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